THE FINANCIAL HEALTH OF THE FEDERAL HOUSING ADMINISTRATION'S SINGLE FAMILY MUTUAL MORTGAGE INSURANCE FUND

HEARING

BEFORE THE

SUBCOMMITTEE ON
HOUSING AND COMMUNITY OPPORTUNITY

OF THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

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THE FINANCIAL HEALTH OF THE FEDERAL HOUSING ADMINISTRATION'S SINGLE FAMILY MUTUAL MORTGAGE INSURANCE FUND

TUESDAY, MARCH 20, 2001

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON HOUSING AND COMMUNITY OPPORTUNITY,
COMMITTEE ON FINANCIAL SERVICES,
Washington, DC.

The subcommittee met, pursuant to call, at 2:05 p.m., in room 2128, Rayburn House Office Building, Hon. Marge Roukema, [chair of the subcommittee], presiding.

Present: Chair Roukema; Representatives Green, Bereuter, Kelly, Cantor, Grucci, Rogers, Tiberi, Frank, Carson, S. Jones of Ohio, Waters, Sanders and Watt.

Chairwoman ROUKEMA. Good afternoon. We will call this hearing to order. And we do appreciate everyone who is here today. I am Congresswoman Marge Roukema, the Chair of the subcommittee. And, of course, we have Mr. Frank, the Ranking Member, here.

I guess I have to say to our panelists that I hope you don't take it personally that there are relatively few people here. It was unfortunate that in scheduling this as far ahead as we had to schedule it, we did not realize that this would not be a voting session until late this afternoon, and unfortunately, many Members are still en route back to Washington today.

That does not mean, however, that our membership is not interested in this subject, and I am sure that there is considerable staff attention being brought to it. And I certainly, and I am sure Mr. Frank will be doing the same, will be informing our Members of the importance and getting to them the record of this hearing, particularly since we are using it to build a foundation on which to handle a number of other important housing issues this year.

So, again, don't take it personally. We shall be certain that your very essential and relevant information is passed on to all the subcommittee Members and certainly to the staff as we deal with them.

As you probably recognize, this is the first hearing of the Housing Subcommittee in this 107th Congress, and I am pleased to be the new Chair of the subcommittee. And as many of you know, or you may remember, I am not a stranger to housing issues, having served as the Ranking Member of the subcommittee from 1987 to 1994.

However, given the dynamic changes over the last 6 years, particularly related, for example, to the economy, whether it is a bullish economy or a bearish economy, and the demographic population shifts, and certainly the evolution of financial markets through innovation and technology and of course the legislation that we passed, Gramm-Leach-Bliley last year, there appeared to be a lot of developing issues confronting the Congress, and certainly we will give them all a fresh look.

But I guess I must refer back to an old saying in this context and acknowledge that saying. Quote: “The more things change, the more they remain the same.” So we will see how that applies to our housing issues.

Having said that, I look back on July 27th, 1993 at a subcommittee hearing where FHA Commissioner Nicholas Retsinas—have I pronounced that correctly? I hope so—Retsinas testified that the 2 percent capital ratio targets mandated by the statute: “Are arbitrary to some extent since no one can define with precision what constitutes a completely sound and healthy fund.”

Mr. Retsinas’ statement sparked an almost decade-long debate on this very issue as to whether or not the 2 percent capital ratio requirements are adequate for the Mutual Mortgage Insurance Fund and to protect it from financial collapse.

Today’s hearing, in which we are going to address this subject, is entitled “The Financial Health of the Federal Housing Administration’s Mutual Mortgage Insurance Fund.” And it was certainly prompted in part by the statement from Mr. Retsinas almost 8 years ago.

And in 1998, as a consequence of those continuing questions, it was requested that we have a GAO study. And the February 28th GAO report is a product of 2 years of work, and I am certain it will, or at least I fully expect, that it will resolve some questions. But at the same time, it may raise others regarding the simple issue of how to measure and adequately protect the FHA Mutual Mortgage Insurance Fund from adverse economic conditions.

And of course we have heard the reports of this past week, although I haven’t yet heard what Chairman Greenspan is announcing today. And I hope no one let us walk in here today if that announcement is being made. I understand that it will probably be sometime mid-afternoon.

Anyway, this hearing is going to focus, regardless of what Greenspan’s action is or whether we are bullish or bearish, this hearing is going to focus on essential elements of the questions that are before us.

The HUD Inspector General’s FHA financial audit for the year 2000, we are going to examine that. And there will be an examination of the explanation and review by the Congressional Budget Office of the Fund as it relates to its estimated economic value and what that means to the Mutual Mortgage Fund.

While there may be some who have a different perspective or perhaps disagree with these witnesses who are before us and their findings, these are the Federal agencies most knowledgeable of the intricate accounting and actuarial analyses necessary to assess the viability of the FHA program.

However—and I want to stress this for all who are here—however, as the subcommittee moves forward on specific issues, there will be an opportunity to hear other experts who may present a different point of view from today's panel.

Questions most likely to be raised in this Congress, for example, are whether the fund is healthy enough to absorb home ownership programs tailored to municipal employees and/or teachers; should the FHA provide premium refunds to those borrowers who paid too much?

Another question: should the premium structure be risk-based?

Is the FHA encroaching—and this is a question that comes up from time to time—is the FHA encroaching on the private sector and its ability to provide low cost mortgage insurance for potential borrowers historically left out of the traditional lending market? That is an essential question.

Ultimately I believe that this debate will also turn on whether or not the Mutual Mortgage Insurance Fund should sustain or contribute to proposed housing production programs.

While we can all agree that there is some extent a housing affordability or availability problem, we are far less certain on the solution to those problems or what the available tools may be of a public policy nature.

I am planning to begin a series of hearings addressing those specific topics. The first hearing is scheduled for April 5th. By the way, again, let me repeat what I said at the beginning. This panel is laying the foundation for future consideration of a whole range of issues.

But anyway, the first hearing is scheduled for April 5th and will focus on two panels. The first panel will be academic experts who have researched this issue and can help define the problem of affordability and/or availability.

The second panel will consist of local practitioners who are providing affordable housing.

Today we do know, however, that the financial soundness of the Mutual Mortgage Insurance Fund is crucial to the FHA single-family program, the cornerstone of our country's single-family mortgage market.

I am hopeful that this hearing will provide a foundation for future hearings on legislative remedies such as:

1. The GAO's recommendation for Congress to specify the economic conditions under which the FHA Mutual Mortgage Fund is expected to be actuarially sound;

2. The impact of new programs and initiatives on the soundness of the Fund; and/or

3. The impact of rebates to borrowers who pre-pay their mortgages, also known as distributive shares.

These are among other issues that may arise.

I am certain that my colleagues will agree that we begin the process today of improving a great home ownership program that will advance the pursuit of the American Dream. And I don't think that we have abandoned or neglected nor should we neglect that fundamental promise of our age, and that is, the American Dream of home ownership.

And with that, I will yield to Mr. Frank, the Ranking Member.

[The prepared statement of Hon. Marge Roukema can be found on page 30 in the appendix.]

Mr. FRANK. Thank you, Madam Chairwoman. And I appreciate your calling this hearing, because it is a very useful one.

There is a terrible housing crisis in this country. Increasingly, it is both a social and an economic problem. In many parts of the country, the voucher program, which has been the major form of housing assistance for the past number of years, is rendered ineffective, as the Chair herself noted in her original memo, because the price of rental housing in so many markets has simply gone beyond what the Federal Government is prepared to support.

And indeed, in areas of very tight supply, the voucher program is flawed on good conservative economic principles. It adds to the demand for housing in a way that is guaranteed to have no positive impact on supply. And the result is inevitably price increase.

It is worth supporting in the absence of an alternative, because it provides some equity. But it clearly has an upward price movement.

So we have got to find ways to increase the supply of affordable housing. And the FHA Fund clearly is one such potential source.

Now there are two issues here: How it is scored and how in fact we decide to deal with it. The scoring is an important piece of the action, but accounting does not dictate policy. Accounting should be accurate. Accounting should give people an accurate discussion of what policy is.

But, we in the Congress have a policy decision to make. There does now appear to be in the Fund more money than can reasonably be expected to be needed, and it is a growing surplus. The question is, what do we do with that growing surplus?

I believe that it makes sense to use some of it to deal with this affordable housing crisis. What we have is the Federal Government as an entity making some money off the FHA, more even than had been anticipated by many. And it is entirely reasonable to look to this housing crisis and try to deal with it.

Now I did note that according to what we were told by the scorekeepers that some use of these funds within the FHA could be done without it being a charge against the surplus.

For example, we had a very successful program years ago, and I think we did more through the Federal Government to create home ownership in the economic levels where we don't easily get it through these programs.

It was selling off part of the inventory that the Federal Government took over from bank failures, both savings and loan failures through the RTC and bank failures through the FDIC, and for low-end housing, we sold it off, not to the highest bidder, but to people who met income qualifications, and it became home ownership.

If I read correctly some of the material I was given, if the FHA were to decide at Congressional direction to take some part of the inventory of recovered houses and put some of that into a program whereby low-income people, people who were below a certain level—80 percent of median is often the number we have used to subsidize housing—if they were allowed to get that housing at a less than highest bidder price, that that would not be a scoring problem.

Now I would be interested in further comments on that. But if that is the case, there is a way for us to get to what is a commonly subscribed goal around here—home ownership for low-income people—using some of these FHA funds in a way that does not implicate the surplus.

That doesn't mean that we shouldn't do other things as well. But we have a surplus being generated, and we have a terrible affording housing crisis, and I think it is incumbent on the Housing Subcommittee to see, as the Chair referred to in her remarks, how these two could fit together.

Now obviously as part of that, I would also be interested in the disaster scenarios and how likely people think they are. And obviously, a disaster scenario would mean that you couldn't touch it.

But I would think that at the very least, the disaster scenario we are told could endanger the FHA mortgage fund, would have an even more important impact. It would probably make it unreasonable by anybody's standards to enact the President's tax cut.

So if we are in fact to govern on the basis of the worst case scenario, it is not just potential uses of the FHA surplus that would be at risk. I think some elements of the President's tax cut would be at risk. And I think we can prudently dismiss some of the more extreme possibilities of disaster. People were asked to tell us what they are.

But I believe if we can show that in all likelihood we are going to have a significant surplus continuing, that it is then our responsibility as the entity in this Congress charged with dealing with our growing housing crisis to try and put that to the best use.

Thank you, Madam Chairwoman.

Chairwoman ROUKEMA. All right. Thank you.

Now I will say to the other Members of the subcommittee that we are open for opening statements from you.

We will first have one, if Mr. Green, the Vice Chairman of the subcommittee, has an opening statement. But for all Members, I want you to know that the opening statements are restricted to 3 minutes by the rules of the Committee.

Mr. Green.

Mr. GREEN. No.

Chairwoman ROUKEMA. All right. Are there any opening statements on the other side of the aisle? All right.

Mr. Sanders.

Mr. SANDERS. Thank you, Madam Chairwoman, and thank you for holding what is in fact a very important hearing.

I would hope that this subcommittee starts off all of its work with the premise that we have a major housing crisis in this country and that this subcommittee is going to do its best to address it. Certainly that is the case in the State of Vermont where we have many, many people who are paying 50 or 60 percent of limited income for their housing.

It seems to me that one way that we can begin approaching this crisis is to use a portion of the FHA and Ginnie Mae surplus to increase affordable housing in this country by creating an affordable housing trust fund. And I will be introducing legislation soon, and I hope Members of the subcommittee will join me in co-sponsoring that legislation.

I think as you know, Madam Chairwoman, according to Deloitte & Touche, FHA profits are expected to exceed $26 billion over the next 7 years. Yet apparently the Congressional Budget Office has testified today that Congress cannot use this funding to increase affordable housing in this country, and I would like to ask why not.

Over recent years, Congress has said that money that is put into the highway trust fund can only be used for highways. Money that is put into the Social Security trust fund can only be used for Social Security. Money in the airway trust fund can be used for aviation needs. But when it comes to the FHA surplus, we are apparently being told that this money must be put back into the Treasury.

I think the time has come for Congress to, at the very least, put a portion of the FHA profits into an affordable housing trust fund to be used only for the purposes of increasing affordable housing opportunities for the American people.

And I thank the Chair.

Chairwoman ROUKEMA. I thank Mr. Sanders.

Mr. FRANK. Madam Chairwoman?

Chairwoman ROUKEMA. Yes?

Mr. FRANK. Can I get unanimous consent to put into the record the statement of the Ranking Member of the Full Committee, Mr. LaFalce?

Chairwoman ROUKEMA. Without objection, so ordered.

[The prepared statement of Hon. John LaFalce can be found on page 33 in the appendix.]

Chairwoman ROUKEMA. Are there any other opening statements?

Yes, Ms. Kelly. You are restricted to 3 minutes for an opening statement. Thank you.

Ms. KELLY. Thank you, Madam Chairwoman. I thank both you and Ranking Member Frank for holding the hearing today on the Mutual Mortgage Insurance Fund.

I think that the FHA has been charged with a mission to assist families of lesser means to realize the American Dream of home ownership, and that is a noble mission.

By accomplishing this through the programs that allow families to put less money down when they purchase their home, that is an important way we get these people into the mainstream. And because of that low downpayment, the program carries a higher risk to the Government.

I think the FHA has highly laudable goals that require the Government assistance to realize, and because of this, the program enjoys really broad bipartisan support.

I hope that we will continue to have that broad bipartisan support. But we also do need to monitor the safety and soundness of the programs, and I do thank you, Madam Chairwoman, for having this hearing today.

I think this issue is a very important one, and I look forward to discussing with the witnesses whether there is, in fact, any real surpluses here that can be used for other programs, as my colleague suggested.

I think obviously we all want to make sure that HUD is doing everything it can to provide safe and clean, affordable housing to people who have lesser means. But I think we also have to ensure that we are not increasing the risk to the American taxpayers that these high risk programs already entail.

So I thank you very much, and I yield back the balance of my time.

Chairwoman ROUKEMA. All right. I thank you. Yes? Is there another opening statement? Yes, Congresswoman?

Ms. CARSON. Yes. I, too, appreciate very much the conveners of this very vital discussion today with respect to the Federal Housing Administration Mortgage Insurance Fund of the Department of Housing and Urban Development. I am probably one of the few people to sit on this panel who received FHA mortgage insurance when I bought my first house. So I am very sensitive to the value of having FHA there as an instrument to ensure that people in low income status with families have an opportunity to embark upon home ownership.

To date, I guess the FHA has insured mortgage loans for over 30 million American families and currently insures around one million new mortgage loans each year with a total principal of around $100 billion, for which I am very proud.

FHA's portfolio of insured loans, as I understand it, now stands at $480 billion, with $6.7 million outstanding loans. I understand that FHA's financial health is always called into question, and that it is measured by the FHA Fund.

According to the General Accounting Office, the Fund's balance is sufficient to withstand moderately severe economic conditions based on historical conditions, and even more severe economic scenarios would have to be accommodated in the event that that occurs. So I would simply echo what my dear friend from Vermont, colleague from Vermont has pointed up. That we don't need to use any of FHA's funds for anything other than for the intent of FHA resources.

It is a good program. It should be maintained. And I did have some concerns about what happened in Baltimore when some 1,400 persons went into foreclosure when they were insured by FHA, and whether or not there has been any experience from that situation that can be used in the future to counteract similar circumstances.

So thank you very much, Madam Chair, and I yield back the balance.

Chairwoman ROUKEMA. Thank you, Ms. Carson. I appreciate that. Other opening statements on either side?

All right. With that, I would have hoped that Mr. Frank would be back by this time. And if not—I don't want to kill any time. Is he coming? Is he on his way? All right.

Just for the record, 2 or 3 minute opening statement, Ms. Jones. Thank you.

Ms. JONES. Thank you, Madam Chairwoman. I am pleased to have an opportunity to be here to discuss the Federal Housing Administration. I am a sophomore in the Congress, and I serve as the Chair of the Housing Committee for the Congressional Black Caucus in Housing, a very important issue as we come on the 107th Congress, and I look forward to the opportunity to hear from each of the presenters that are here today and to make inquiry as well.

Thank you very much, Madam Chairwoman. See, I am a good filler for you.

Chairwoman ROUKEMA. Thank you very much. That is very cooperative. And with that, I would make that note that without objection, all Members' opening statements will be made part of the record.

Now I will turn to our panel now and note for them, I will introduce each one of you individually, but I would like to note for the panel that your full written statements will be made part of the record.

However, in the interest of time and recognizing that we have a lot to do this afternoon with many Members who are interested in asking questions, that you will be recognized for 5 minutes to summarize your testimony, but that the full statement of your testimony will be part of the record.

So I will recognize first Mr. Thomas J. McCool, who is presently Managing Director of Financial Markets and Community Investment of the General Accounting Office, the GAO. We are very pleased to have you here today with your testimony regarding the Mutual Mortgage Insurance Fund and the balance of that and the economic conditions that we are currently facing.

I introduce Mr. McCool, and we look forward to your testimony, because it is central to what the future holds for us in this subject.

Thank you. Mr. McCool.

STATEMENT OF THOMAS J. McCOOL, MANAGING DIRECTOR, FINANCIAL MARKETS AND COMMUNITY INVESTMENT, GENERAL ACCOUNTING OFFICE

Mr. MCCOOL. Thank you, Madam Chairwoman and Members of the subcommittee. We are pleased to be here today to discuss the results of our analysis of the financial health of the Mutual Mortgage Insurance Fund of the Department of Housing and Urban Development's Federal Housing Administration.

Through the Fund, FHA operates a single family insurance program that helps millions of Americans buy homes, particularly low-income families and first-time home buyers.

In fiscal year 1990, the Fund was estimated to have a negative economic value and its future was in doubt. Congress enacted legislation that required the Secretary of HUD to take steps to achieve a capital ratio of 2 percent by November 2000 and to maintain or exceed that ratio at all times thereafter.

As a result of these reforms, the Fund must not only meet the capital ratio requirements, it must also achieve actuarial soundness. That is, the Fund must contain sufficient reserves and funding to cover estimated future losses resulting from the payment of claims on foreclosed mortgages and administrative costs.

However, the legislation does not define actuarial soundness.

The 1990 reforms require that an independent contractor conduct an annual actuarial review of the fund. These reviews have shown that during the 1990s, the estimated economic value of the fund, its capital resources plus the net present value of future cash flows, grew substantially.

As you can see from the figure to your left, by the end of the fiscal year 1995, the Fund attained an estimated economic value that slightly exceeded the amount required for a 2 percent capital ratio.

On that graph, the gray area represents 2 percent of the unamortized insurance-in-force. The white area represents the actual economic value. As you can see, after 1995, the economic value is greater than 2 percent for all years.

In fact, this past year, for fiscal year 2000, Deloitte & Touche estimated the economic value of the Fund to be about $17 billion, which was 3.51 percent of the Fund's insurance-in-force.

You asked us to estimate the economic value of the Fund and also to determine the extent to which a 2 percent capital ratio would allow the Fund to withstand worse-than-expected loan performance.

I am going to talk first a little bit about our measure of the value of the Fund, which is actually quite comparable to Deloitte & Touche, so I won't spend too much time on that, and then move onto the potential stressors that we put the Fund through, at least in a theoretical sense.

The economic value of the Fund consists of current capital resources and the net present value of future cash flows. Investments in non-marketable Treasury securities represent the largest component of FHA's current capital resources.

Estimating the net present value of future cash flows is a complex actuarial exercise that requires extensive professional judgment. Cash flows into the Fund from premiums and the sale of foreclosed properties, as you can see again in the diagram to your left. Cash flows out of the Fund to pay claims on foreclosed mortgages, premium refunds, and administrative expenses.

We estimate that the Fund had an economic value of about $15.8 billion at the end of fiscal year 1999. This estimate implies a capital ratio of 3.2 percent of the unamortized insurance-in-force.

Although we did not evaluate the quality of Deloitte's estimates, which were prepared using a different method of analysis, we believe that our results and Deloitte's are comparable because of the uncertainty inherent in forecasting and the professional judgment made in this type of analysis.

Much of the difference seems to be a result of performing the analyses at different times. Deloitte had to do its analysis a little earlier, before the fiscal year was over, and therefore had to estimate the capital resources, and Deloitte admits that it probably overestimated the 1999 number by about $1 billion.

The Fund's economic value principally reflects the large amount of capital resources that the Fund has accrued. These capital resources are the result of previous cash flows which reflect the robustness of the economy.

The estimated value of future cash flows also contributed to the strength of the Fund at the end of fiscal 1999. Many of the loans in the current portfolio were insured in recent years under conditions of low interest rates and a robust economy.

As a result, our models predict low levels of foreclosure and prepayment and that cash flowing into the Fund for mortgages already in the portfolio will be more than sufficient to cover the cash outflows associated with these loans.

Now this again is all under certain assumptions about the economic future, that is the expected economic future.

However, to provide a framework within which actuarial soundness can be assessed, we need to move beyond estimates of the capital ratio under expected economic conditions. We believe that to determine actuarial soundness, one should measure the Fund's ability to withstand worse-than-expected conditions, although how much worse is a more difficult judgment.

We generated economic scenarios that were based on economic events in the last 25 years, and other scenarios that could lead to worse-than-expected loan performance in the future.

Most of the scenarios we looked at had only a small impact on the capital ratio. For example, the worst historical scenario we tested, one based on the 1981-82 national recession, lowered the capital ratio by less than 4⁄10 of a percentage point, that is from about 3.2 to about 2.8, about 20 percent of the required 2 percent capital ratio.

To see how the economic value of the Fund would change as the extent of adversity increased, we extended regional scenarios based on historical economic downturns experienced in three States to the Nation as a whole. In two of these cases, the estimated capital ratio was about 1 percentage point lower than in the base case, which again was 3.2 percent.

However, our models estimated that extending the New England downturn to the country as a whole would reduce the capital ratio by almost 2.4 percentage points; again, this means from 3.2 to about .8.

In another scenario in which we specify that interest rates fall substantially, inducing refinancing, and a substantial recession sets in that leads to increased foreclosures, the estimated capital ratio also fell substantially, by over 1.8 percentage points.

Now in our economic scenarios, we didn't always generate foreclosure rates that were as high as those that were actually experienced in the 1980s. So in one of our exercises, we actually imposed historical foreclosure rates from the 1986 to 1990 timeframe on the years 2000 through 2004. And again, historical foreclosure rates at that level would reduce the capital ratio by over 2 percentage points.

Chairwoman ROUKEMA. Mr. McCool, can you summarize your testimony?

Mr. MCCOOL. Sure. I'm sorry. I'm just getting to the end here.

Chairwoman ROUKEMA. You've gone through 5 minutes, but this is very important, so I'm going to be a little liberal with the time commitment to you.

Mr. MCCOOL. That's OK. I'm sorry I'm taking so long. I guess the two final points that I'd like to make with respect to our results are, first of all, while we think our models make good use of historical experience, there are some limitations that people need to be aware of.

In particular, a lot of the portfolio, the current FHA portfolio, is composed of fairly recent loans, and we have very little experience with those loans, and so we don't know how they're going to perform in the future.

The second point is that there are changes that are being undertaken by the FHA program that could have effects on, again, the performance of the portfolio, but they're fairly recent changes, and again, we don't know how they're going to affect the portfolio.

Also, we are not estimating the effect of new loans, that is to say, loans made after the end of fiscal year 1999, which again will affect the portfolio in the future.

And then the last point I'd like to make is simply that whether actions should be taken to change the value of the Fund depends on whether the Fund's capital resources and expected revenues exceed the amount needed to meet its expected cash outflows under designated stressful conditions, that is, whether the Fund is actuarially sound. Because we believe that actuarial soundness depends on a variety of factors that could vary over time, setting a minimum or target capital ratio will not guarantee the Fund will be actuarially sound over time.

We believe that to evaluate the actuarial soundness of the Fund, one or more scenarios that the Fund is to withstand would need to be specified. Then it would be appropriate to calculate the economic value of the Fund or the capital ratio under the scenarios.

As a result, we believe the Congress may wish to consider taking action to specify criteria for determining when the Fund is actuarially sound. More specifically, Congress may want to consider defining the type of economic conditions under which the Mutual Mortgage Insurance Fund would be expected to meet its commitments without borrowing from the Treasury.

Madam Chairwoman, this concludes my statement. I would be pleased to answer any questions.

[The prepared statement of Thomas J. McCool can be found on page 43 in the appendix.]

Chairwoman ROUKEMA. I thank you. I'm sure there will be a number of questions. You have given a full menu of analyses there, and I thank you.

Now we have Ms. Susan Gaffney, Inspector General of the U.S. Department of Housing and Urban Development. Welcome, Ms. Gaffney. You've been here before, and we appreciate your attendance today.

STATEMENT OF HON. SUSAN GAFFNEY, INSPECTOR GENERAL, U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Ms. GAFFNEY. Thank you, Madam Chairwoman. As I've pointed out in my written statement, we in the HUD OIG are not actuaries. And so my testimony is going to be a little to the side. It's going to be based on our audit and investigative work in the HUD OIG.

Whatever the forecasts and assumptions are, I think we can all say that the MMI Fund is in terrific shape relative to where it has been.

What I want to talk to you about today is, please, don't let that disguise some of the problems that exist in the MMI. I would say that Single Family has been our major preoccupation over the last 2 or 3 years in terms of audits and investigations.

We now have—these won't sound like big numbers to you, but they are big numbers for us—more than 250 criminal investigations ongoing involving more than 2,000 single family loans. And what we are finding is that we cannot keep up with the number of cases that keep coming to us.

Fraud seems to be growing in the Single Family Program. You've heard about this. I'm telling you our numbers are small here, but as we increase staff, we increase the cases.

What happens is that the people who are being victimized by this kind of fraud are often the people that we're trying to help with the FHA program. And the other thing you see with this fraud, and it was alluded to before, is that it tends to be concentrated in certain cities in certain neighborhoods.

So, you have seen the stories about Baltimore, where there is a big problem, and Harlem, where we had 203(K) fraud really destroying major communities.

We have done a lot of audit work on the Single Family Program. You can't stop all fraud. Someone will always find a way to commit fraud. But we believe that there are internal controls in the program that need to be tightened up to prevent it and to protect the people we're trying to help with FHA-insured mortgages.

If you look at the FHA financial audit that was just prepared by KPMG and just issued by our office, what you see is that FHA has been making progress. They've done a lot of good things, but they still have some big problems.

To summarize that, they got an unqualified opinion, but they have a material weakness in their information systems. They have three other reportable conditions, which are other serious internal control weaknesses. But, on the other hand, since last year, they've corrected four other reportable conditions.

What I would like you to focus on, if not now, then in one of your future hearings, is that there are two basic problems in FHA that persist as shown in the financial audit. One is they have information systems that are 10 to 20 years old. They are locally based. They are not integrated. It is very difficult to run a program of this magnitude involving this amount of money without up-to-date information systems.

FHA has a plan to bring their information systems up to speed by 2005. But if you look at the progress that has been made to date, I think you would have to question that goal.

The second issue in FHA is personnel. In Single Family, their personnel have been cut by half. But more than that, FHA Single Family is big business. This isn't like processing widgets. This is big business. We need people who know the business, who are paid so that we can attract them, and we need to know that we have the right number of people.

The trouble is, neither FHA nor HUD knows right now how many people they need.

So, I would ask you, as you consider FHA and MMI, to keep in mind that FHA needs some flexibility. They need some flexibility to solve their problems, to get their information systems up to speed, to hire the right kind of people, to train them right, get them on board. And with those attributes, I am convinced that we can overcome the problems that the OIG audits and investigations keep finding.

[The prepared statement of Hon. Susan Gaffney can be found on page 73 in the appendix.]

Chairwoman ROUKEMA. Thank you, Ms. Gaffney. I appreciate that testimony.

And now the final panelist is Mr. Marvin Phaup, Deputy Assistant Director for Microeconomic and Financial Studies, the Congressional Budget Office. We welcome you.

STATEMENT OF MARVIN PHAUP, DEPUTY ASSISTANT DIRECTOR FOR MICROECONOMIC AND FINANCIAL STUDIES, CONGRESSIONAL BUDGET OFFICE

Mr. PHAUP. Thank you, Madam Chairwoman. I am pleased to participate in today's hearing on the FHA's Mutual Mortgage Insurance Fund.

Chairwoman ROUKEMA. Excuse me. Could you move the mike up closer? We are not able to hear you.

Mr. PHAUP. I'm pleased to participate in this hearing.

Chairwoman ROUKEMA. That's much better.

Mr. PHAUP. Your letter of invitation asked CBO to address a fairly narrow question. The question was, does the MMIF have a surplus that can be spent on meeting new housing needs? The answer to that question is no.

Under current rules governing the budget process, rules to which the Congress has at least tacitly agreed, it is absolutely clear that MMIF balances do not constitute new budgetary resources available for new spending.

The rule that there are no free lunches applies fully here, because accumulations of premiums in excess of the required minimum are available under current law only for paying insurance claims.

If the Congress decides to spend money to meet new housing needs, it should do so independently of the estimated net position of the MMIF. But, of course, if the Congress takes such action, this would probably have a cost and reduce the budget surplus.

Fund balances do not constitute authority to enter into any new obligations, not even for new guarantees. Appropriation action is required before FHA can issue new commitments. Through the budget process, the Congress approves the making of new FHA loan guarantees by setting an annual limit on the loan volume. In 2001, that limit is $160 billion.

But it is that process and not the existence of any estimated net balance in the Fund that provides the resources for FHA to make new loan guarantees.

I would close my brief statement by making three additional observations. The first is that the MMIF provides policymakers with information, not budgetary resources. Even though the MMIF is not a source of funding for new housing needs, it can be a useful accounting device. And accounting itself is not everything. As Mr. Frank said, at best, it can only inform policy decisions.

The second point I would make is that these estimates of the economic value, or net position, of the MMIF provide policymakers with information about the performance of these programs in terms of an important objective; namely, that program costs under some reasonable long-term economic scenarios will be covered by premiums. That is useful and important information.

The third thing I would say is that even though these long-term estimates of Fund balances are uncertain and move around a lot—you have heard much about re-estimates and estimates of the Fund balances—and even though they're not a source of new budgetary resources, for a variety of good management and good policy reasons, they're well worth making and monitoring carefully.

So while my answer to the narrow question is negative, but based on the rules under which the Congress operates, I want to emphasize that the FHA actuarial reviews have important program and policy value nonetheless.

That concludes my statement.

[The prepared statement of Marvin Phaup can be found on page 87 in the appendix.]

Chairwoman ROUKEMA. All right. I thank you very much. I'll tell you, you've given us a lot to think about here and a lot of detail. I will ask one or two questions, and I'm not sure, but that your testimony didn't give me a full answer. But if it did, I didn't hear it. And I'm going to begin with Mr. McCool.

You did talk extensively about the actuarial soundness and the questions of the reserve ratios. But may I ask the question this way. Do you believe that Congress should take action? Is there an action required here for Congress in terms of whether or not the existing system meets your recommendations as to what should be done with various types of economic conditions? You postulated a few different circumstances. But I wasn't quite sure as to whether or not you absolutely agreed that the existing system is adequate, or does Congress need to require a ratio that would cover catastrophic conditions that might be projected out there?

Mr. MCCOOL. Well, I think the answer is that 2 percent, as I think everyone knows, is a fairly arbitrary number.

Chairwoman ROUKEMA. Yes. That is what we are trying to get at here.

Mr. MCCOOL. Two percent could be actuarially sufficient under certain circumstances, and it may not be sufficient under others, both in terms of the composition of the portfolio and also with respect to, again, the risks that Congress is trying to ensure against.

Our recommendation is that Congress think about setting forth some actuarial soundness criteria. What sort of scenarios the Congress wants the FHA Fund to be able to withstand, I think, is what we're asking for.

Just as an example, it's not necessarily the perfect example. But in the 1992 Act that set up OFHEO, the regulator of Fannie Mae and Freddie Mac, Congress did set forth, maybe some would say, a very specific set of scenarios that were to be the basis for a capital ratio for Fannie Mae and Freddie Mac. Again, it may have been overly specific in some people's mind or maybe not specific enough. But it certainly is much more of a rigorous actuarial safety and soundness standard, rather than just say 2 percent or put in some number.

So I think what we're looking for is something that sets forth a little bit more criteria about what you mean by actuarial soundness for the Fund.

Chairwoman ROUKEMA. What do you mean by actuarial soundness for the Fund?

Mr. MCCOOL. Well, again, we don't know whether you want the Fund to be able to protect against the Great Depression or to protect against a moderate downturn or a small downturn.

Chairwoman ROUKEMA. I see.

Mr. MCCOOL. You have to protect the taxpayers' money. You have to decide what the Fund should be—how big it should be to protect that and what the risks are you are concerned about.

Chairwoman ROUKEMA. So there is a lot of discretion here and a lot of—all right. All right. We will look over that again in some detail.

Ms. Gaffney, I do have question for you. And I am not quite sure whether—I don't think you were explicit in your testimony. If so, I kind of missed it. But you made inferences. In the context of the fraud that you talked about, I am not quite sure how you account for this increasing fraud.

But it raised in my mind the question is HUD contracting out too much of its oversight responsibilities to private companies? Is that what you were inferring here, or does that have no relationship to the increasing fraud questions that you are talking about? And how that relates to the internal controls that you have existing now.

Ms. GAFFNEY. I don't think there is a right answer to how much you contract out, but it's clear that you shouldn't contract out from weakness. I think what all of us have learned is that when you contract work out, you had better have people on your own staff who know that work better than the contractors do—so they can monitor and hold the contractors accountable.

I think what has happened sometimes in HUD is, because of the downsizing of the staff, that we have contracted out without having that component of in-house staff truly able to monitor and hold the contractors accountable.

Chairwoman ROUKEMA. All right. You have alluded to the second question that I had in mind. That was the question as to whether or not we have provided adequate—have enough full time, qualified employees to provide that lender oversight, adequate lender oversight. And you are indicating maybe we don't.

Ms. GAFFNEY. We believe from what we have seen that FHA does not have sufficient trained staff to provide adequate lender oversight. The problem, though, is that neither HUD, nor have we, done a tight analysis to know what that right staffing level should be.

I understand, though, that something may be in the works now to do that. It is really very important.

Chairwoman ROUKEMA. Or maybe we should be giving more attention to how we select those private companies and what criteria they have to meet.

Ms. GAFFNEY. That is also true.

Chairwoman ROUKEMA. Yes. All right. Thank you.

Mr. Frank.

Mr. FRANK. I want to begin by expressing my appreciation for General Gaffney's acknowledgement that sometimes we can cut too far, and that this notion that less Government is always better and that staff who are pejoratively called bureaucracy, can always be cut and that you can have the private sector make it up.

I mean, I appreciate your pointing out the fallacy of that kind of thinking. And I agree that we have cut the HUD staff too far, and we then wind up blaming HUD, because having cut the staff too far, we have an agency that is not able to fully carry out its responsibilities.

I also do have to note that with all the problems, it does appear that with the concerns we had about the FHA, that the previous Administration did leave it in pretty good shape, and now the question is, how do we preserve and build on that?

And we have gotten some negative economic scenarios here about, you know, what it would take to cause this fund to go negative. So, Mr. Phaup, I would be interested, CBO is in the business of doing economic projections. According to CBO's economic projections, how likely are we to see the disaster scenario in the economy that would wipe out this fund?

Mr. PHAUP. Well, Mr. Frank, it is very unusual for us to predict cyclical downturns. Our long-term budget projections almost always show some trend rate of growth, even for forecasts that look 1 and 2 years ahead. I can't remember the last time that we predicted a recession that we weren't already in.

Mr. FRANK. Is this some inherent institutional optimism that we have here? What is this?

Mr. PHAUP. I think it is a matter of professional intellectual limitation. That it's just very difficult.

Mr. FRANK. I'm reminded of our late colleague, former colleague, Jake Pickle's question, and maybe I would reform it: "Is Rosy Scenario the highest ranking woman at the CBO?"

Mr. PHAUP. I'm not sure our scenarios are rosy with respect to where we end up in the long run.

Mr. FRANK. All right. Well, now that you've discounted the CBO forecasting, let me repeat my question.

Mr. PHAUP. All right.

Mr. FRANK. Given the inherent optimistic bias to which, for the first time in my experience, CBO has now confessed, what in CBO's projections is the likelihood of the kind of disaster scenario that would wipe out this Fund?

Mr. PHAUP. As far as I know, we do not have any projections that would be sufficiently severe to do so.

Mr. FRANK. OK. In CBO's range, I know we've all seen that range of projections.

Mr. PHAUP. Or distribution projections.

Mr. FRANK. And even at the low end of CBO's projections, you would not see this Fund——

Mr. PHAUP. I could not say that. We generally focus on the midpoint.

Mr. FRANK. You've seen the projection. Let me say, I would be interested at the low end of the projections whether you think that's like that. But you think it's very unlikely, according to your projections?

Mr. PHAUP. Certainly the ones that we base our baseline projections on, yes.

Mr. FRANK. All right. I appreciate that. And I think this. If you look at this Fund and you look at the way things are going, not only is it unlikely that we would have the kind of level of disaster that would wipe us out, but if we were to legislate the FHA Fund on that basis, it would be the only element in the Federal Government where we legislated on that basis.

That is, the extremely pessimistic assumptions that it would take to see this being wiped out would be applied only for the purposes of dealing with that.

Let me ask through the GAO to Mr. McCool, you've given on page 18 some of the historical periods, but they were regional, sectional. Has there been in recent times—or let me put it this way. When was the last time the economy was at the point overall which would represent a scenario that would wipe out the Fund?

Mr. MCCOOL. That would wipe out the Fund? I'm not sure that in the postwar period it has occurred.

Mr. FRANK. It's never happened since the postwar period?

Mr. MCCOOL. No.

Mr. FRANK. Thank you. That reassures me that we can now think about how to spend it. So let me now go back to Mr. Phaup and the CBO. Nobody is projecting it. It has never happened, so I'll let somebody else worry about it.

If we were in fact to do some adjustment of prices within the FHA's inventory, is it possible to do that without triggering a scoring and and so forth?

Mr. PHAUP. My answer would be that if the Congress directed a particular action, it would be scorable. If the Secretary took some action under existing authority, it would not be a scorable act; we would just adjust our baseline for it.

Mr. FRANK. What if Congress—you said if we directed it, it's scorable, and if it's done under existing authority, it's not scorable. What if we changed existing authority to empower, but not direct the Secretary?

Mr. PHAUP. We have some budget analysts here. They say they would like to read the legislation before they offered an opinion.

[Laughter.]

Mr. FRANK. Oh, well, see, you want to read the legislation before you decide whether to score it, and we want to read the opinion before we write the legislation.

[Laughter.]

Mr. PHAUP. I understand that.

Mr. FRANK. So we may get into it.

Thank you, Madam Chairwoman.

Chairwoman ROUKEMA. Isn't that, giving that kind of discretion, isn't that—that's rearranging all the chairs on the Titanic, isn't it? No?

Mr. FRANK. But we're not on the Titanic, as we've just seen.

Chairwoman ROUKEMA. I'd like to ask the OMB Director that, please. Is it?

Mr. FRANK. You'd better summon him, then, because he's not here.

Chairwoman ROUKEMA. I'm sorry. I'm sorry. You know who I'm talking about. CBO. CBO. I'm sorry. I meant CBO.

Mr. PHAUP. Under existing law, the Secretary has the authority to take certain actions that, as Mr. McCool can testify more fully, would affect the net position of the fund, including actions such as changing the premium, which he did in January of this year. And he also can take action to resume the distributive shares program, if he takes into account four or five statutorily imposed criteria first.

So these possibilities are already a part of existing law.

Chairwoman ROUKEMA. All right. We will have to think about that.

Mr. Green, please, the Vice Chairman.

Mr. GREEN. Thank you, Madam Chairwoman.

Ms. Gaffney, in your testimony you made reference to the increasing use of foreclosure avoidance techniques. I'm intrigued by that. Can you tell me what those techniques include?

Ms. GAFFNEY. Well, the simplest, most straightforward one is the lender would call the borrower and try to see what the problem is, see whether there is a short-term fix, some kind of short-term hiatus in payments; whether there is a longer term fix, such as extending the term of the mortgage or counseling about how to budget funds in order to pay the mortgage, that kind of reaching out.

Mr. GREEN. So very much what is done in the private sector with conventional lenders?

Ms. GAFFNEY. Exactly. That is what the Federal Government is trying to emulate, yes.

Mr. GREEN. Can you tell me why it is that those techniques or the use of them appear to be a recent occurrence with FHA?

Ms. GAFFNEY. I don't know, but that is very much the case that when we looked at this 2 years ago. FHA was really just starting. We're going to be looking at them again. But I'll ask a colleague, if you don't mind.

Mr. GREEN. Sure.

Ms. GAFFNEY. Oh, the assignment program.

Chairwoman ROUKEMA. Excuse me. Could you speak into the microphone, please?

Ms. GAFFNEY. Sorry. I should have known the answer to that one. You'll remember the assignment program under which defaulted loans were assigned to HUD, and then HUD kept them forever and ever and ever, and it created a huge problem, and then the Congress finally stopped the assignment program.

It was at that time that we started loss prevention.

Mr. GREEN. OK. Is that also why FHA has had a much higher foreclosure rate over the years than some of its private sector counterparts?

Ms. GAFFNEY. That's one possibility. But FHA is trying to fill a niche in the market that the private sector doesn't. And I think all the statistics show that FHA is meeting that need.

It's the higher loan-to-value ratios, it's targeting minority borrowers, it's targeting portions of cities where other lenders fear to go.

Mr. GREEN. I'm sure that may have some effect, but obviously there are housing authorities around the Nation that serve those sectors of the market very well and don't have a higher foreclosure rate. So I mean I think it's a little bit dangerous to say that just because you're serving that sector of the market that you're necessarily going to have a higher foreclosure rate.

Ms. GAFFNEY. No, absolutely. I didn't mean to imply that. I meant that HUD is—HUD/FHA—is willing to accept somewhat lower standards in order to offer mortgage insurance to these groups of people, particularly first-time homeowners.

Mr. GREEN. Thank you.

Mr. McCool, I guess I'm going to try to get at the same issues or conditions that the previous questioners have had.

We've heard reference to something between the Great Depression and a moderate downturn in the economy. Given that breadth there, is there anything you can do to help us learn more about what kind of conditions the Fund at its current level could in fact withstand?

Mr. McCool. Well, again, within the scenarios that we played out, the Fund, at least at 3.2 percent, was able to withstand the shocks.

Now again, remember that a lot of what that results from is the fact that we're starting from a very good starting place. And so we're introducing shocks that are shocks of 4 or 5 years.

And what happened in the 1980s that actually caused the Fund to become negative in 1990 was a series and a sequence of shocks that also were played out in an economy that wasn't in the same situation to start with. It was an economy with very high interest rates in the early 1980s, a national recession followed by some regional shocks.

So none of the individual shocks we introduced starting from where we are was able to deplete the Fund. But again, that doesn't mean that a sequence of shocks, starting from a slightly different place, couldn't deplete the Fund.

Mr. Green. Could you help me a little bit?

Mr. McCool. I'm sorry.

Mr. Green. Define a little bit more what a "shock" is.

Mr. McCool. Well, again, in our scenarios, or in this case it's effectively a substantial downturn in the economy, and in particular one that generates falling housing prices and higher unemployment, and, as a result, leads to higher foreclosures for the FHA.

Mr. Green. OK. Madam Chairwoman, that's it for my questions.

Chairwoman Roukema. I thank the Vice Chairwoman.

Congresswoman Waters.

Ms. Waters. Thank you very much, Madam Chairwoman. Most of the questions have been raised I think. Most of us are interested in knowing how we can take this good information about a surplus and turn it into housing opportunities for the people who are in such desperate need.

I've heard it described recently as a housing crisis out there in America where we have people who are living four and five families to one residence. We have people who have been waiting in line for housing. We have underfunded Section 8, on and on and on.

So while we are very conscious that we must comply with the law relative to the use of the surplus, we are looking for options that can take us to the kind of outcomes that we are desirous of having in order to deal with this crisis.

So I'm just wondering if I can hear some positive speculation about how can we do this. I know we may have uncertain outcomes, but as you think about this, you think about the good and you think about the bad. I want to hear what thoughts you may have about what we can do to use this opportunity to increase housing for people who are in desperate need. Anybody?

Mr. Phaup. Well, Ms. Waters, I think my message is so limited that I'm not sure it's going to be responsive. But what I would say, based on this statement, is simply that given these needs that you describe, the right surplus to think about doing something with is not the surplus in the MMIF but the on-budget surplus.

In other words, it's the whole budget surplus that's the right number to look at in terms of what you want, what policy actions you may want to take, rather than these balances in this Fund. That's a very narrow answer, but that's the best I can do.

Ms. WATERS. What would you suggest, if the surpluses continue to grow in this Fund, what would you suggest we do? Just watch it grow and grow and grow? I mean, what would you suggest?

Mr. PHAUP. Well, I think that the 1990 Act actually envisioned some downward adjustments. Perhaps one of the others here would disagree, but it seems to me that the 1990 Act envisioned the use of distributive shares as a way of keeping the balance from building up—the use of lower premiums to prevent the balance from building up—and I think those actions are already authorized for the Secretary.

Ms. WATERS. Well, it appears from my reading that we have taken some of those actions, and we still have a growing surplus. Are there any other thoughts about how we can utilize this for the good of the consumers out there? For people—what else can we do? Even if you do it on the front end.

For example, I'm listening to Ms. Gaffney talk about the fraud and talk about people who are being qualified for loans who are not able perhaps to pay back, some of those descriptions here.

But what we have learned about creative thinking in this area is you can do no downpayments. As I understand it, there is nothing that has proven that people who make downpayments pay their mortgages any better than people who perhaps would not make any downpayments.

We are talking about, as you described, the processes that are being used to try and keep people out of foreclosure. And you say in your report that you are not sure it is working, that maybe it may extend the length of time, but the foreclosure takes place anyway. What can we do with these funds on the front end to help people early who come in under special arrangements? What can we do to help them avoid foreclosure, not waiting until they get in trouble?

I mean, are there ways that we can assist first-time home buyers and others so that we can do a better job that we are doing today with this?

Ms. GAFFNEY. Ms. Waters, the answer to that is, absolutely, you know that there are a number of things we can do.

I really lack expertise in what Marvin is talking about, which is the legality of how you can use these funds. But, I always thought that the Congress enacted laws, revised laws, and assuming that the President signed those laws, that that's what governed how we operate.

Ms. WATERS. You are not incorrect. We look to those of you who——

Chairwoman ROUKEMA. Excuse me. Will you conclude your question now? You're long over your 5 minutes, Congresswoman.

Ms. WATERS. All right. Then I'll yield back.

Chairwoman ROUKEMA. No, no. Just finish your last statement.

Ms. WATERS. OK. We look to those of you who have some responsibility in these areas to help us understand as best we can what is happening out there so we can try and fix it, we can try and promote ways by which to be more effective, all of that. So that is why we inquire of you and query you in such ways so that we can gain information about what we can do to be helpful to the American citizens.

And when I said that I was looking for some discussion on positive incomes, I am very serious about that, because we want to know how to be cost effective and effective period in helping consumers and people who want homes and loans and mortgages.

Ms. GAFFNEY. Right. I am restrained—those are all policy decisions, and I'm not supposed to be involved in policymaking decisions.

Obviously, everyone knows there is a crisis in affordable housing. In my limited world of audits and investigations, there is a need to help people from being the victims of fraud. And people really are being victimized.

Ms. WATERS. We can use the surplus to do some of that.

Ms. GAFFNEY. Yes.

Ms. WATERS. All right. Thank you.

Chairwoman ROUKEMA. All right. Thank you.

Excuse me. May I just make the point for all Members that if anyone has additional questions that you haven't had time for, aside from maybe a second round here, you may submit those questions to the panelists in writing for their response.

Congressman Bereuter, please.

Mr. BEREUTER. Thank you, Madam Chairwoman. Between trying to do some things on the House floor and attending a hearing, this has not been most successful day at a hearing. So I'm sorry I didn't hear all the testimony.

I've been trying to read some of the written material provided to us. I'm wondering if I could cut through to what seems to me to be a basic question, Mr. Phaup, if I could address you.

With respect to the Fund's estimated economic value and the insurance-in-force, we're at 3.66 in the 1999 economic value. That is well over the requirement. And I am looking at the headline items in the GAO report provided to us and seeing that the 2 percent capital ratio appears sufficient to withstand some worse-than-expected loan performance.

What is "worse than expected"? What kind of an economic downturn would give us something that would still say the 2 percent capital ratio is sufficient? For example, are we talking about something more severe than the period between 1983 and 1985? Or how steep an economic downturn would we have to have to find that 2 percent was not adequate? Can you help me with that, Mr. Phaup?

Mr. PHAUP. Mr. Bereuter, I am usually not reluctant to answer questions, but I believe Mr. McCool should speak to that. Those are his model simulations.

Mr. MCCOOL. Again, I think that when we put our models through individual historical stresses, because of where we're starting from, they did not generate the defaults and foreclosures that we actually experienced in the mid-1980s. So part of it is a slight disconnect.

If we look at the actual foreclosure rates that we experienced in the 1980s, those rates can bring the Fund down, according to our estimate, by more than 2 percent.

Mr. BEREUTER. Brings it down by more than 2 percent?

Mr. MCCOOL. By more than 2 percent. It would bring it down from 3.2 to .9 in our scenario where we expose the Fund to the same foreclosure rates that we experienced, the economy experienced in the 1986 to 1990 timeframe.

Again, that is just one scenario. It is not necessarily the right scenario or the best scenario, but it is one scenario.

Mr. BEREUTER. Let me proceed to the next step. And maybe it is you, Mr. Phaup, that ought to get this question. Maybe it is Mr. McCool. I know that, Mr. Phaup, you're not in a position where you can give us policy recommendations.

But is there any out-of-the-box thinking about how we can bring down the ratio and still provide adequate protection by a change in legislation or some other mechanism that will enable us to bring down those resources and to use them for other purposes and still have a failsafe kind of approach in case we have a very severe economic downturn?

Have you done a survey which suggests that there is thinking out there which gives us any kind of alternative to the current system that we have in place by statute?

Mr. PHAUP. We have not. I would like to pass on offering an answer to that.

Mr. BEREUTER. I think that Ms. Gaffney is not the person to answer this, unless she just happens to have run into something. But Mr. McCool?

Mr. MCCOOL. Again, I think that our view is that it's up to the Congress to decide what minimum ratio it wants, what target ratio it wants and then, again, what it wants to do with anything that it feels is—I won't say left over. That's not the right way to think about. But again, there is no right answer for minimums. There is no right answer for targets. It depends on the riskiness of the portfolio.

Mr. BEREUTER. Well, we could set a different target if we understood that there was a different system that could be checked in when we run into a really severe economic downturn. And I am wondering if you can give us any guidance as to what people might think as an alternative to relying strictly on the current statutory mechanism we have in place.

Mr. MCCOOL. Well, again, our view is you should try to set the Fund at a level that will protect you from a downturn that you fear.

Mr. BEREUTER. That is almost a waste of resources in the meantime.

Mr. MCCOOL. Well, I understand that. But the problem is that once things start to turn down, then it's hard to build up the resources. That's the reason why you, in a sense, prefund these systems.

I understand that that's not necessarily the easiest way to think about it. But part of the problem is that when things do start to turn sour, it's hard to build up funds.

Mr. BEREUTER. Madam Chairwoman, I hope we might look at some less conventional approaches as a failsafe on this. I don't know what they might be, but surely someone must have thoughts about this subject.

It seems to me this is a waste of resources to keep an excessive amount here during all this period of time and yet in the possibility that we're going to have a very severe economic downturn.

Chairwoman ROUKEMA. Yes. There are pros and cons to that.

Mr. BEREUTER. And I yield back.

Chairwoman ROUKEMA. And I guess underlying all of it is what someone said earlier on, and that is, there are no free lunches. But we have to make some sound fiscal judgments about these things.

Mr. FRANK. If the gentleman would yield.

Chairwoman ROUKEMA. This hearing today opens up a whole number of questions which we will take up in subsequent—I don't know whether or not you were here earlier. I know you were here initially, but when I made the statement that this will be the foundation for probably a series of hearings maybe from others in the field who have different perspectives.

So we'll look to you to work with you on that.

Mr. BEREUTER. I did hear that, and that's a good basis. If I had time, I would yield to the gentleman.

Mr. FRANK. I think we're well beyond it not being any free lunch. At this point, we're buying lunch for about 2077, and we're putting the money aside. And I think we're not talking about free lunch, we're talking about, or alternatively, the most expensive lunch I ever saw, or we're assuming the price will go up.

But I think it's not a case of a free lunch. I think the gentleman from Nebraska is right. We've put aside far more money than by any rational justification we've heard seems necessary.

Chairwoman ROUKEMA. Well, the question is, what do you do with insurance policies? How broadly or how in-depth do you need insurance policies?

We'll go on now to our Congresswoman Jones here who is waiting patiently.

Ms. JONES. Thank you, Madam Chairwoman.

My first question goes to Ms. Gaffney. I was in my Congressional district last week where I attended an event where a community development corporation participated in the grant program to take over HUD housing that had been in the community kind of standing on its own—not standing on its own—but was dilapidated, and accepted a grant to be responsible for the oversight of rebuilding and remodeling these homes.

And I want you to know, it was such a wonderful feeling to see a woman, a single woman with five children, excited that she had a chance to have a home of her own.

And the other thing that made it so good for me, it was in the neighborhood that I live, but I also grew up in, but to walk into this home. It was a five bedroom home in a low-, middle-income neighborhood.

But the woodwork was mahogany. The third floor was wood slated from the floor to the ceiling with windows all around. I said a lot of people would love to be able to get in these neighborhoods and get these homes.

But my point is that your conversation about loans, trying to work on loan mitigation with foreclosure—before it got to foreclosure—excuse me. Wouldn't it make sense that we spend some of these dollars on programs that educate people about what it means to buy a home and how their credit will be spent and perhaps reduce the cost of high risk mortgages down the line?

Ms. GAFFNEY. I'm going to get myself in big trouble if I say how these funds should be used.

Ms. JONES. I'm asking you a question so when you go back, tell them I asked you the question so you were forced to answer. Then you won't have to worry about it.

Ms. GAFFNEY. Let me tell you, the educational part of it is so absolutely key. You know, really, the people who are being victimized by this fraud, they are people who are being offered deals that you and I would say, "Hey, that's so crazy. That can't possibly be true."

These people don't know that.

Ms. JONES. And let me cut you off for a moment. Wouldn't it even make sense to spend some of these dollars dealing with the predatory lenders that are preying on our communities and let some of those dollars be used to pull them back in?

Because it's clear that many of the foreclosures occur under circumstances where people who understood financing and who had a little more education, and it doesn't mean they shouldn't be in a home, but if they had a little more education, would never enter into these loan agreements anyway.

Ms. GAFFNEY. I could not agree with you more.

Ms. JONES. Let me take it a little bit further. My experience as a prosecutor doesn't let you answer. I just ask the questions.

[Laughter.]

Ms. JONES. Wouldn't it also be important that HUD spend some time—and I see you made this in your statements somewhere—with regard to looking at the lenders themselves and saying you cannot put them out of business.

When they enter into agreements that are causing the kind of losses that you suggest might occur under the circumstances, that they ought not be able to lend at all, and that way, some of us wouldn't be in the dilemma that we are in.

Ms. GAFFNEY. For sure.

Ms. JONES. Let me ask you, Mr. McCool. I'm not quite understanding—do I have your statement? Is this you? Yes, Mr. McCool.

On page 13 it says, "If, for example, FHA loosens underwriting standards, future loans may perform worse than past experience suggests. In addition the recent reduction in up-front premiums could reduce cash inflows into the Fund, although it could also lower the riskiness of the loans that FHA insures."

Upon what basis do you say that future loans may perform worse that past experience suggests just because they loosen underwriting standards?

Mr. MCCOOL. Only in the sense that if you do lower underwriting standards, you increase the pool and you increase the potential riskiness of that pool. It doesn't necessarily mean it's a bad thing.

Ms. JONES. Well, let me ask you this. If the underwriting standard was—and at some point this is what it was in many African-American communities—is you couldn't be black and get a loan, that didn't cause any greater loss for people when African-Americans had a chance to purchase homes, right?

Mr. McCOOL. No, no. Again, we're talking about legitimate underwriting standards.

Ms. JONES. Well, I'm questioning the legitimacy of some of the underwriting standards that denied low-income and minority persons opportunities to purchase homes that are still in place. The race is not there, but it's there still.

Mr. McCOOL. I understand. I think that, again, we would presume that the underwriting standards were based on true estimates of financial risk. If they're based on arbitrary rules of thumb, that's a very different issue.

Ms. JONES. Give me an example of what are true underwriting standards for the record, please.

Mr. McCOOL. Well, again, there are relationships between net worth and income and likelihood of being able to maintain loans of a particular size. Those sorts of things.

Ms. JONES. I mean we've very recently——

Chairwoman ROUKEMA. Mr. McCool, would you speak more closely into the microphone, please?

Ms. JONES. This is my question, Madam Chairwoman.

Chairwoman ROUKEMA. Please.

Ms. JONES. More recently last year HUD decided to allow Section 8 dollars to be used for downpayment for purchase of homes. By them doing that, does that lower the underwriting standard, because these people previously didn't have downpayment dollars to buy homes?

Mr. McCOOL. I wouldn't think it would, no.

Ms. JONES. OK. So that's a good program. Maybe we could use some of the surplus then to allow for no downpayment loans. I think someone else suggested that. But maybe we could use some of these funds where we've got people in a dilemma where they can't afford to buy a home. I didn't hear that answer.

Mr. McCOOL. There's lots of——

Ms. JONES. You're like my son who's 17. I say "Hello, Marvin, how are you?" He'll go——

Mr. McCOOL. There's lots of ability to increase flexibility, I'm sure. And I don't mean to be personal.

Chairwoman ROUKEMA. Excuse me.

Ms. JONES. I'm just trying to get some real issues, thank you, Madam Chairwoman, on the record, with regard to the inability of people to buy homes. I thank you very much for your time.

Chairwoman ROUKEMA. And I would remind the members of this panel that you do have the opportunity to come back for the record with fuller explanation or amplification if you feel you haven't had time.

But we will go on to Mr. Frank.

Mr. FRANK. Thank you, Madam Chairwoman. I got the distinct impression from at least Mr. McCool and Mr. Phaup that a desire to answer more fully is not one of the things that is greatly motivating them at this point.

[Laughter.]

Mr. McCOOL. It depends on the question.

Mr. FRANK. I don't think either one of them felt deprived. My question, because it's relevant to the kind of policy judgments that might be made, in the pricing policies of FHA, they get revenues from at least three sources. There's the up-front premium, there's the annual payment and there's sales, auction sales when they repossess.

How precisely is the internal pricing? That is, my impression is that there might very well be elements of cross-subsidy and that the goal is to produce an overall balance and that it's not very carefully done from an internal pricing standpoint. Am I accurate on that, Mr. Phaup, Mr. McCool?

I mean, when they say, you know, this class of property—is each class of property sort of standing on its own or is it as long as it comes out well in the end is that OK?

Mr. McCool.

Mr. MCCOOL. Well, again, my understanding is they have certain flexibility, but it's with respect to types of loan programs and the extent of, for example, the loan-to-value ratio affects the premiums. They are fairly broad categories though.

Mr. FRANK. Mr. Phaup.

Mr. PHAUP. I agree. That there are cross-subsidies in the FHA program, no doubt.

Mr. FRANK. I appreciate that, Madam Chairwoman, because that seems to me to give us some flexibility to urge the FHA administrator to——

Mr. PHAUP. Urge?

Mr. FRANK. Not us. I understand, Mr. Phaup, we can't do it. Only the Executive can do it by itself. But it does give us some flexibility to urge the FHA administrator to take advantage of his ability or her ability to cross-subsidize and have a different policy outcome since there are cross-subsidies now.

That's all. Thank you. And don't elaborate on that in writing. I'm happy with what you said.

[Laughter.]

Chairwoman ROUKEMA. If you can ask a real short question and then I'll conclude.

Ms. JONES. Mr. Phaup, I didn't get to ask you this. And I'm new at this. Who makes a decision as to how the funds of the MMI are invested to make returns on those dollars?

Mr. PHAUP. The U.S. Congress. Current law requires that those balances be held in Treasury securities.

Ms. JONES. Would you suggest that they be done somewhere else to make it advantageous for the Fund or not?

Mr. PHAUP. I would not as a special case for FHA. That's a big overall question that the Congress now has before it and will deal with further.

Ms. JONES. Anything but Social Security. Anyway, go ahead.

Mr. PHAUP. Yes. I'm thinking about Social Security. But there are plenty of other cases where people have exactly the same interest, and that's an important policy question that deserves careful weighing. I wouldn't make the change for one program only.

Ms. JONES. Thank you, Madam Chairwoman.

Chairwoman ROUKEMA. All right. Thank you. I do want to thank this panel and also remind them that according to the rules of our

Committee, Members who have additional questions will have up to 30 days to submit them to the panel members.

I would simply submit one more question to you, not for answer now, but for you to supplement what was said in the panel concerning my question regarding the fraud that you have indicated has been increasing and what we do with the private companies that are dealing with these issues. Are they part of this fraud question? And how we deal with this growing problem and whether it needs additional legislation or whether it's strictly administrative ways that we can do it.

Because I think it was indicated that fraud is increasing and that there are more needs for internal controls, and I did acknowledge what you stated about the need for more full-time employees to deal with this.

But I think we have to deal with the private sector as well, and if we could get the advantage of your experience on the ground and in the real world, whether or not it's purely administrative or whether there's a need for legislative corrections.

And with that, I thank you very much, and we appreciate your contribution. And as I said, it will be the foundation for future action. Thank you.

[Whereupon, at 3:35 p.m., the hearing was adjourned.]

A P P E N D I X

March 20, 2001

Opening Statement of the Honorable Marge Roukema
Subcommittee on Housing and Community Opportunity

Hearing on "The Financial Health of the Federal Housing Administration's (FHA) Mutual Mortgage Insurance Fund"

Tuesday, March 20, 2001

Good Afternoon.

Today marks the first hearing by the Subcommittee on Housing and Community Opportunity, since I became Chairwoman.

As many of you know, I am not a stranger to housing issues, having served as the Ranking Member of this Subcommittee from 1987 to the end of 1994. However, given the dynamic changes over the last six years, particularly related, for example, to our growing economy, demographic population shifts, and the evolution of financial markets through innovation and technology, there appears to be a lot of new issues confronting this Congress that will require a fresh look. However, I must also acknowledge the old saying—"the more things change, the more they stay the same."

Having said that, I beckon back to a July 27, 1993 Subcommittee hearing where then FHA Commissioner Nicolas Retsinas testified that the 2% capital ratio targets mandated by statute "are arbitrary to some extent, since no once can define with precision what constitutes a completely sound and healthy fund." Mr. Retsinas' statement sparked an almost decade-long debate on whether the 2% capital ratio requirements were adequate to protect the Mutual Mortgage Insurance Fund from financial collapse.

Today's hearing is entitled "The Financial Health of the Federal Housing Administration's (FHA) Mutual Mortgage Insurance Fund," which was prompted, in part, by Mr. Retsinas statement almost eight years ago and this Subcommittee's 1998 request to GAO. The February 28th GAO report is the product of two years of work and I am certain that it will resolve some questions and perhaps raise others regarding the simple issue of how to measure and adequately protect the FHA Mutual Mortgage Insurance Fund from adverse economic conditions.

This hearing will also focus on:

- the HUD Inspector General's FHA financial audit for FY 2000; and,
- an explanation and review by the Congressional Budget Office of the fund as it relates to its estimated economic value and what that means to the mutual mortgage fund.

While there will be some who have a different perspective or perhaps disagree with these witnesses' findings, these are the Federal agencies most knowledgeable of the intricate accounting and actuarial analysis necessary to assess the viability of the FHA program.

However, as the Subcommittee moves forward on specific issues, there will be an opportunity to hear other experts who may present a different view from today's panel of government experts. Questions most likely to be raised this Congress, for example, are: whether the Fund is healthy to absorb homeownership programs tailored to municipal employees and/or teachers? Should FHA provide premium refunds to those borrowers who paid too much? Should the premium structure be risk-based? Is FHA encroaching on the private sector and its ability to provide low-cost mortgage insurance for potential borrowers historically left out of the traditional lending market?

Ultimately, I believe, this debate will also turn to whether the Mutual Mortgage Insurance Fund should sustain or contribute to a proposed housing production program. While we all can agree that there is to some extent a housing affordability or availability problem, we are far less certain on the solution or available tools.

I am planning to begin a series of hearings addressing that specific topic. The first hearing is scheduled for April 5th and will focus on two panels. The first panel will be academic experts who've researched this issue and can help define the problem of affordability and/or availability. The second panel will consist of local practitioners who are providing affordable housing.

Today, we do know, however, that the financial soundness of the Mutual Mortgage Insurance Fund is crucial to the FHA single family program—the cornerstone of this country's single family mortgage market.

I am hopeful that this hearing will provide a foundation for future hearings on legislative remedies such as (1) GAO's recommendation for Congress to specify the economic conditions under which the FHA mutual mortgage fund is expected to be actuarially sound; (2) the impact of new programs and initiatives on the soundness of the fund; or, (3) the impact of rebates to borrowers who prepaid their mortgages, also known as distributive shares, among other issues.

I am certain, and my colleagues will agree, that we begin the process today of improving a great homeownership program that will advance the pursuit of the American dream.

I yield to Mr. Frank.

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Statement of

Rep. John J. LaFalce

Submitted to the

Housing and Community Opportunity Subcommittee

of the

House Banking Committee

Hearing on FHA's

Mutual Mortgage Insurance Fund [MMIF]

March 20, 2001

I am pleased to submit this statement for today's Housing and Community Opportunity Subcommittee hearing on the FHA Mutual Mortgage Insurance Fund.

The FHA Single Family Loan Program

Since its inception in 1934, FHA has helped create homeownership opportunities for over 30 million Americans. In recent years, it has played an important role in our nation reaching a record homeownership rate of over 67%. FHA currently insures mortgage loans for some one million Americans a year (a significant portion of whom cannot otherwise obtain a loan) while consistently generating annual profits of several billion dollars a year – profits which swell our nation's budget surpluses.

Today's hearing is further affirmation of the financial strength of the FHA program and of the FHA Fund. Ten years ago, the FHA Fund had a negative fund balance of $2.7 billion. As a result of 1990 FHA reforms, a strong economy and sound stewardship under the last Administration, the FHA Fund now has a Fund balance as of the end of fiscal year 2000 of over $16.9 billion, according to the latest independent actuarial study by Deloitte and Touche. According to that same study, under expected economic conditions, the Fund is projected to grow to over $43 billion over the next seven years. And according to the GAO report being presented today, the Fund can withstand an number of increasingly severe economic scenarios and still not be depleted.

Strengthening FHA

What should our priorities be for FHA in the future. First, we should build on the management reforms made by the previous Administration. Last year, successful loss mitigation efforts to keep people in their home and reduce foreclosure costs increased by over 50%, to more than 30,000 borrowers. FHA should also build on HUD's recent efforts to target lenders with significantly above-average default rates, and to implement the Homebuyer Protection Plan, which identifies property defects before a loan is made.

Reinvesting in FHA

Secondly, we ought to reinvest in the FHA program. The HUD Secretary recently did just that, through a 75 basis point reduction in the up-front premium. This action reduced the up-front cost of FHA loans by as much as $1,755 per loan.

But we can and should do more to make FHA even more effective. To that end, I have recently introduced three bills which I urge the committee and Congress to act on. First, along with Rep. Leach, I re-introduced the HOUSE Act (H.R. 674). The HOUSE Act authorizes 1% down FHA mortgage loans for pre-kindergarten through grade 12 teachers, policemen, and firemen buying a home within the school district or local jurisdiction that employs them. In addition, the bill defers the 1.5% up-front loan fee that FHA customarily charges and, as an incentive to continued public service, waives the fee entirely after five years of continuous service.

The purpose of this legislation is to strengthen our communities by making it easier for policemen, firemen, and teachers to live within the community they serve. This also gives jurisdictions help in recruiting and retaining these essential public servants. The HOUSE Act is supported by the Fraternal Order of Police, the International Association of Firefighters, the American Federation of Teachers, the National Education Association, and the American Association of School Administrators.

Last year, the Congressional Budget Office estimated that this legislation would generate 125,000 new loans to teachers, policemen, and firemen over the next five years. CBO also determined that the bill would actually **increase** the federal budget surplus by $162 million over the same period. Thus, passage of the HOUSE Act would not technically reinvest surplus FHA profits, but would actually make them larger.

I have also introduced two other bills designed to expand homeownership, reduce defaults on FHA loans, and simplify the process of securing an FHA loan.

The first bill, the *"FHA First-time Homebuyer Act"* [H.R. 859] would pass along to first-time homebuyers the savings from HUD's recent cut in the FHA up-front loan fee into a dollar for dollar reduction in the required down payment. In addition, by conditioning this down payment reduction on a requirement of homeownership counseling, the legislation would reinstate the financial incentive for first-time homebuyers to undergo pre-purchase homeownership counseling, thus reducing default rates for these borrowers.

Late last year, HUD reduced the up-front premium customarily charged on single family FHA loans from 2.25% to 1.50% of the loan amount. However, because of a quirk in the statutory formula which sets maximum loan limits, not a single dollar of this premium reduction accrues to the borrower with respect to lowering the down payment. Thus, a major portion of the benefit of the fee reduction benefit is deferred until the loan is pre-paid or paid off – which could be years or even decades later. My legislation would allow 100% of the recently announced FHA fee reduction to be passed along to a first-time homebuyer in the form of a reduced down payment. This will have the effect of reducing a borrower's down payment by as much as $1,755, depending on the loan size. Reduced down payments will make it easier for young families to buy a home.

Moreover, this down payment reduction will not pose a risk to the FHA single family mortgage fund, since maximum loan-to-value levels, even with this change, will not be any higher than they were prior to last year's fee reduction. In practice, the legislation would have the effect of reducing defaults, because the lower down payment option is conditioned on the borrower competing a course in homeownership counseling.

The second bill, the *"FHA First-time Homebuyer Act"* [H.R. 858] would make permanent the FHA down payment simplification formula, which is scheduled to expire in December of next year. This formula is widely considered to be a tremendous improvement over the confusing, two-part down payment formula that preceded it.

Unfortunately, our recent practice of providing only a periodic extension of this improved down payment formula has resulted in unneeded uncertainty. Last year, as its interim status was about to expire, the FHA Commissioner was forced to issue a clarification that loans closed before October 1st, but insured after October 1st were eligible for the simplified treatment. Subsequently, Congress was forced to step in to pass a stop-gap 30-day extension, and then a further 26 month extension of the simplified formula, through December, 2002. A permanent extension, supported by the major real estate organizations, would avoid these periodic crises.

Finally, in the near future, I plan to reintroduce legislation to authorize the reinvestment of profits from FHA hospital loan programs into FHA-insured hospitals. A major component of this effort is to authorize grants and loans to FHA-insured hospitals which want to convert excess hospital capacity into related health care use. In areas with overcapacity, this would be good both for the hospital and the local health care market.

Reinvesting the Surplus

The third issue is whether we can and should "reinvest" the surplus profits from the FHA single family loan program. It is important that this issue is not simply framed as a technical question of whether the HUD Secretary **can** use FHA profits to fund other housing programs without Congressional approval or whether Congress **can** do so without such additional spending being scored under our budget rules. According to the experts testifying today, the answer to both of these questions is clearly no.

But the real question is whether Congress **should** increase funding for affordable housing, and whether some or all of the projected $26 billion a FHA profits (negative credit subsidy) over the next seven years should be used entirely to increase the federal budget surplus, or whether a portion of such profits should be used to increase funding for affordable housing. Congress has every right to re-invest some of these profits, and in my opinion, it should do so.

In this respect, I would point out that pursuant to recent scoring changes by CBO and OMB, all of the $2.4 billion in FY 2002 FHA profits will be credited to the HUD account, and to the net budget totals that will appear in the VA-HUD appropriations bill. The Bush Administration FY 2002 budget takes 100% of these profits and uses them to offset housing spending. It then goes on to cut a further $2.2 billion in real spending on housing programs, compared to the FY 2001 budget.

This approach should be rejected. Based on housing need in this country – with over 5 million families with worst case housing needs and almost a million homeless – we ought to be increasing, not cutting funding for affordable housing. Based on our nation's available resources - with trillions of dollars in federal surpluses over the next decade - we clearly can afford to make this investment. Finally, as Congress weighs this decision, it is not unreasonable to take into account the growing FHA profits, which reduce our budget surplus, in deciding how much of that surplus we should invest in housing.

OPENING STATEMENT

House Financial Services Committee
Chairman Michael G. Oxley
March 20, 2001
Subcommittee on Housing and Community Opportunity

"The Financial Health of the Federal Housing Administration's Single-Family Mutual Mortgage Insurance Fund"

Thank you Chairwoman Roukema.

Today marks the first housing Subcommittee hearing since I became Chairman of this Committee. As many of you know, the cornerstone of the American dream is homeownership. When our citizens own homes, they put down roots and therefore have a greater stake in their communities' growth, safety and development.

Today's hearing on the financial health of the Federal Housing Administration's (FHA) mutual mortgage insurance fund will provide a foundation for our Committee Members on the mortgage finance system. Since FHA's creation in the 1930s, it has been an innovator of the single family mortgage market that is envied throughout the world. While homeownership rates are at an all-time high of 68%, certain population sectors, such as minorities and inner-city neighborhoods, still face affordable housing challenges and still hover in the 40th percentile for homeownership.

The task of this Committee will be to ensure that FHA is strong and complements those private-sector efforts necessary to bring the homeownership to even more Americans.

I am proud that the Committee on Financial Services will play an integral part in widening the reach of that American dream. I look forward to Mrs. Roukema's leadership in this area.

Statement by Rep. Bernard Sanders regarding the FHA Surplus

First, I would like to thank Chairwoman Roukema for holding this important hearing regarding the financial health of the Federal Housing Administration's (FHA) Single-Family Mutual Mortgage Insurance Fund.

I believe that we cannot begin to talk about this issue until we first address the affordable housing crisis in this country. Madame Chairwoman, we all acknowledge that the issue of affordable housing has rapidly become a serious national problem -- one where thousands of low income elderly, disabled, and families with children are increasingly unable to afford privately-owned low income housing units. According to HUD, about 5.4 million Americans today are paying more than half of their limited incomes on housing or living in severely substandard housing. Since 1990, the number of families who have ``worst case" housing needs has increased by 12 percent -- that's 600,000 more American families who cannot afford a decent and safe place to live. For these families living paycheck to paycheck, one unforseen circumstance, a sick child, a needed car repair, or a large utility bill can send them into homelessness

According to a recent report by the National Low Income Housing Coalition, my state of Vermont is the fourth least affordable state for renters. 50% of Vermont renters are unable to afford the state median fair market rent of $607, including utilities, for a two-bedroom apartment. Another study conducted by the state of Vermont found that state and federal housing programs have been able to meet the needs of only 15,000 of the 37,000 Vermont rental households needing assistance.

Madame Chairwoman, this is an outrageous situation that must be addressed. The question is where do we begin? I think a good first start is to use a portion of the FHA and Ginnie Mae surplus to increase affordable housing in this country by creating an affordable housing trust fund. I will be introducing this legislation soon, and I hope that Members of this Subcommittee will join me in co-sponsoring this legislation.

Madame Chairwoman, according to Deloitte & Touche, FHA profits are expected to exceed $26 billion over the next seven years. Yet, apparently the Congressional Budget Office has testified today that Congress cannot use this funding to increase affordable housing in this country. I would like to ask why not?

I would point out that the President chose to use the projected $2.4 billion in FHA profits in FY 2002 not to increase affordable housing opportunities for hard working Americans, but to lower the net level of funding for housing. If the President can use the FHA profits to lower the net level of funding for housing, why can't Congress use the same FHA profits to increase affordable housing in this country?

Over recent years, Congress has said that money that is put into the Highway Trust Fund can only be used for highways; money that is put into the Social Security Trust Fund can only be used for Social Security; money that is put into the Airway Trust Fund can only be used for aviation needs; but when it comes to the FHA surplus, we are apparently being told that this money must be put back into the Treasury. I think the time has come for Congress to, at the very least, put a portion of the FHA profits into an affordable housing trust fund to be used only for the purposes of increasing affordable housing opportunities for hard working Americans.

I thank the Chair.

United States General Accounting Office

GAO

Testimony

Before the Subcommittee on Housing and Community Opportunity, Committee on Financial Services House of Representatives

MORTGAGE FINANCING

Actuarial Soundness of the Federal Housing Administration's Mutual Mortgage Insurance Fund

Statement of Thomas J. McCool, Managing Director
Financial Markets and Community Investment

GAO
Accountability * Integrity * Reliability

Madam Chairwoman and Members of the Subcommittee:

We are here today to discuss the results of our analysis of the financial health of the Mutual Mortgage Insurance Fund (Fund) of the Department of Housing and Urban Development's (HUD) Federal Housing Administration (FHA). Through the Fund, FHA operates a single-family insurance program that helps millions of Americans buy homes. The Fund, which is financed through insurance premiums, has operated without cost to the American taxpayer. Last year, the Fund's economic value appeared to have reached its highest level in at least 20 years—prompting proposals to spend some of the Fund's current resources or reduce net cash flows into the Fund. Concerned about how the soundness of the Fund is measured and proposals to spend what some were calling "excess reserves," you requested that we analyze the financial health of the Fund.

Since 1990 the economic health of the Fund has been assessed by measuring the economic value of the Fund—its capital resources plus the net present value of future cash flows—and the related capital ratio—the economic value as a percent of the Fund's insurance-in-force. For most of its history, the Fund was relatively healthy; however, in fiscal year 1990 the Fund was estimated to have a negative economic value, and its future was in doubt. To help place the Fund on a financially sound basis, Congress enacted legislation in November 1990 that required the Secretary of HUD to, among other things, take steps to achieve a capital ratio of 2 percent by November 2000[1] and to maintain or exceed that ratio at all times thereafter. The legislation also required the Secretary to raise insurance premiums and suspend the rebates, called distributive shares, that FHA borrowers had been eligible to receive under certain circumstances. As a result of the 1990 housing reforms, the Fund must not only meet capital ratio requirements, it must also achieve actuarial soundness; that is, the Fund must contain sufficient reserves and funding to cover estimated future losses resulting from the payment of claims on foreclosed mortgages and administrative costs. However, neither the legislation nor the actuarial profession defines actuarial soundness.

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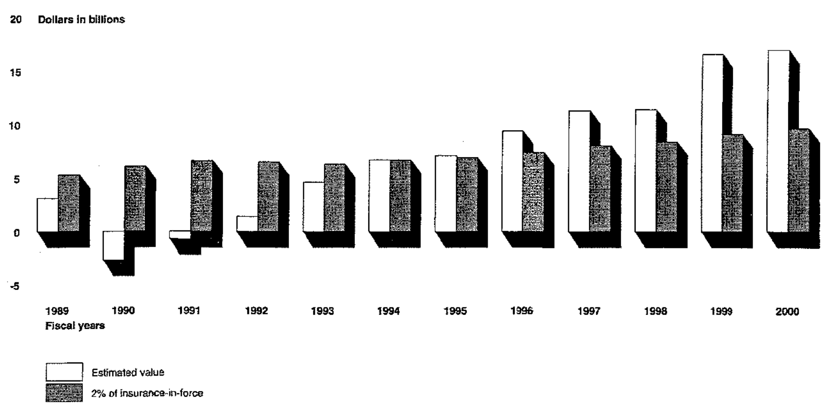
[1]The act defined the capital ratio as the ratio of the Fund's capital, or economic net worth, to its unamortized insurance-in-force. However, the act defined unamortized insurance-in-force as the remaining obligation on outstanding mortgages—a definition generally understood to apply to amortized insurance-in-force. FHA has calculated the 2-percent capital ratio using unamortized insurance-in-force

The 1990 FHA reforms required that an independent contractor conduct an annual actuarial review of the Fund. These reviews have shown that during the 1990s, the estimated economic value of the Fund grew substantially. As figure 1 shows, by the end of fiscal year 1995, the Fund attained an estimated economic value that slightly exceeded the amount required for a 2-percent capital ratio. Since that time, the estimated economic value of the Fund continued to grow and always exceeded the amount required for a 2-percent capital ratio. In the most recent review, Deloitte & Touche (Deloitte) estimated the Fund's economic value at about $17.0 billion at the end of fiscal year 2000. This represents about 3.51 percent of the Fund's insurance-in-force—well above the required minimum of 2 percent.

Figure 1: Comparison of Estimated Economic Value and 2 Percent of Insurance-in-Force, 1989-2000



Source: GAO analysis of Price Waterhouse (now PricewaterhouseCoopers) and Deloitte & Touche data.

Concerned about the adequacy of the minimum 2-percent requirement and about proposals to spend what some were calling excess reserves, you asked us to determine the conditions under which an estimated capital ratio of 2 percent would be adequate to maintain the actuarial soundness of the Fund. Specifically, you asked us to (1) estimate the value of the Fund at the end of fiscal year 1999, given expected economic conditions, and compare our estimate to the

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as it is generally understood—which is the initial amount of mortgages. All capital ratios reported here are measured using unamortized insurance-in-force as it is generally understood.

estimate of the value of the Fund reported by HUD for that year; (2) determine the extent to which a 2-percent capital ratio would allow the Fund to withstand worse-than-expected loan performance due to economic and other factors; and (3) describe some options for adjusting the size of the Fund if the estimated capital ratio is different from the amount needed and describe the impact that these options might have on the Fund, FHA mortgagors, and the federal budget.

In summary:

- We estimate that the Fund had an economic value of about $15.8 billion at the end of fiscal year 1999. This estimate implies a capital ratio of 3.20 percent of the unamortized insurance-in-force. Although we did not evaluate the quality of the 1999 estimates prepared by Deloitte, using a different method of analysis, we believe that Deloitte's estimates and ours are comparable because of the uncertainty inherent in forecasting and the professional judgements made in this type of analysis. Both of these estimates easily exceed the minimum required capital ratio of 2 percent that Congress set in 1990.

- Given the economic value of the Fund and the state of the economy at the end of fiscal year 1999, a 2-percent capital ratio appears sufficient to withstand moderately severe economic downturns that could lead to worse-than-expected loan performance. That is, under economic scenarios that we developed to represent regional and national economic downturns that the nation experienced between 1975 and 1999, the estimated capital ratio fell by only slightly less than 0.4 percentage points. Some more severe downturns that we analyzed also did not cause the estimated capital ratio to decline by as much as 2 percentage points. However, in three more severe scenarios, an economic value of 2 percent of insurance-in-force would not have been adequate. Nonetheless, because of the nature of such analysis, we urge caution in concluding that the estimated value of the Fund today implies that the Fund would necessarily withstand any particular economic scenario under all circumstances.

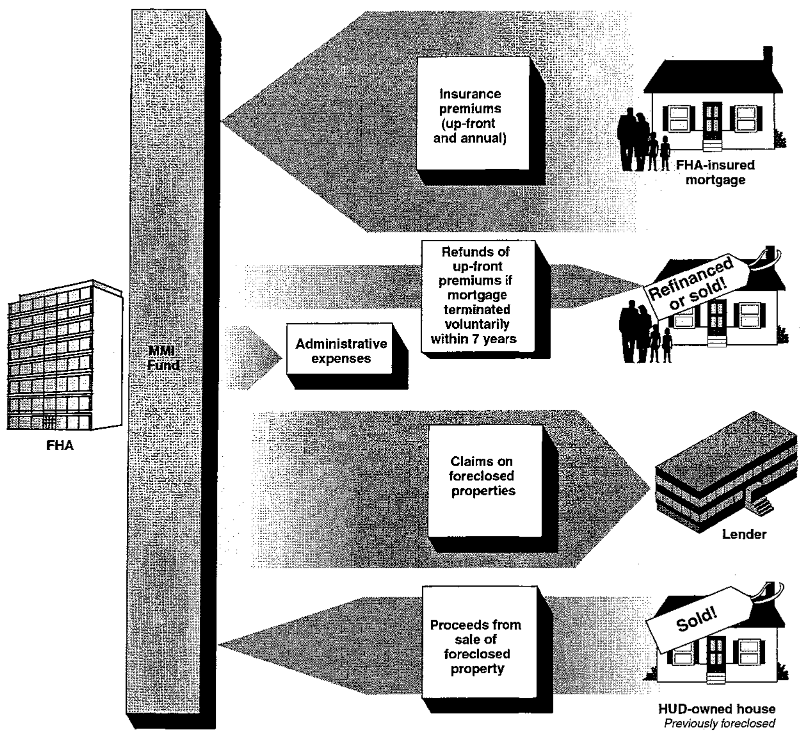
- Congress and the Secretary of HUD have taken and could take a number of actions to influence the economic value of the Fund. The impact that these actions have on the capital ratio and FHA borrowers is not always certain. However, actions that influence the Fund's reserve levels will also affect the federal budget. In short, any proposal that seeks to use reserves, if not accompanied by a reduction in other spending or an increase in receipts, will result in a decline in the federal budget surplus.

Let me start by describing our estimates of the Fund's economic value and capital ratio and how our estimates compare with estimates prepared by Deloitte & Touche.

The Fund's Capital Ratio Exceeds 3 Percent

The economic value of the Fund consists of current capital resources and the net present value of future cash flows. Investments in nonmarketable Treasury securities represent the largest component of FHA's current capital resources. Estimating the net present value of future cash flows is a complex actuarial exercise that requires extensive professional judgment. Cash flows into the Fund from premiums and the sale of foreclosed properties; cash flows out of the Fund to pay claims on foreclosed mortgages, premium refunds, and administrative expenses. (See fig. 2.)

Figure 2: Cash Flows of the Mutual Mortgage Insurance Fund



At the end of fiscal year 1999, the Fund had capital resources of $14.3 billion. Using our models and forecasts of likely values of key economic variables, we estimated that the Fund had a net present value of future cash flows of $1.5 billion at that time. This yielded an estimated economic value of $15.8 billion and a capital ratio of 3.20 percent. Given the inherent uncertainty of these estimates and the professional judgements involved, these numbers are comparable to those of Deloitte at the end of 1999, when Deloitte estimated that under expected economic conditions the capital value was $16.6 billion and the capital ratio was 3.66 percent. Much of the difference seems to be the result of performing the analyses at different times. Because Deloitte performed its analysis before the end of fiscal year 1999, it had to estimate the Fund's capital resources and insurance-in-force, while we were able to use the year-end values. In its recent estimates for 2000, Deloitte noted that in the actuarial review for fiscal year 1999, it had overestimated the Fund's capital resources by about $1 billion. However, Deloitte did not restate the economic value and capital ratio for 1999; instead it adjusted the starting point for the 2000 estimate of economic value. If Deloitte had restated the economic value and capital ratio for fiscal year 1999, the 1999 values would likely have been smaller. Because Deloitte uses estimates for the Fund's capital resources and insurance-in-force, it is difficult to compare its estimates of the Fund's economic value and capital ratio over time.

Table 1: Estimates of Capital Ratios for FHA's Mutual Mortgage Insurance Fund by GAO and Deloitte & Touche, End of FY 1999

Dollars in millions

Estimate	Total capital resources	Future cash flows	Economic value	Unamortized insurance-in-force	Capital ratio (percent)
GAO	$14,326	$1,484	$15,810	$493,990	3.20
Deloitte	15,331	1,306	16,637	454,184	3.66

Source: GAO analysis and *Actuarial Review of MMI Fund as of FY 1999,* Deloitte & Touche.

The Fund's economic value principally reflects the large amount of capital resources that the Fund has accrued. Because current capital resources are the result of previous cash flows, the robustness of the economy and the higher premium rates throughout most of the 1990s accounted for the accumulation of these substantial capital resources. Good economic times that are accompanied by relatively low interest rates and relatively high levels of employment are usually associated with high levels of mortgage activity and relatively low levels of foreclosure; therefore, cash inflows have been high relative to outflows during this period.

The estimated value of future cash flows also contributed to the strength of the Fund at the end of fiscal 1999. As a result of relatively low interest rates and the robust economy, FHA insured a relatively large number of mortgages in fiscal years 1998 and 1999, and these loans make up a large portion of FHA's insurance-in-force. Because of their low interest rates and because forecasts of economic variables for the near future show house prices rising while unemployment and interest rates remain fairly stable, our models predict that these new loans will have low levels of foreclosure and prepayment. At the same time, we assume that many FHA-insured homebuyers will continue to pay FHA annual insurance premiums.[2] Thus, our models predict that cash flowing into the Fund from mortgages already in FHA's portfolio at the end of fiscal year 1999 will be more than sufficient to cover the cash outflows associated with these loans.

The future cash flows are estimates based on a number of assumptions about the future, including predictions of mortgage foreclosures and the likelihood that those holding FHA-insured mortgages will prepay their loans. These predictions are based on elaborate models that estimate past relationships between foreclosures and prepayments and certain economic variables, such as changes in house prices. To the extent that these relationships are different in the future, the actual foreclosures and prepayments will differ from the estimates. The estimating procedures make many other assumptions, and I will describe some of these limitations in greater detail later in my testimony.

The Actuarial Soundness of the Fund Depends on the Risks That Congress Wants the Fund to Withstand

Although our estimates and Deloitte's estimates of the Fund's capital ratio under expected economic conditions are comparable, we cannot conclude on the basis of these estimates alone

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[2] Most borrowers with FHA-insured loans who received them prior to September 1983 were required to pay an annual insurance premium for the life of the loan. In addition, most borrowers who received FHA-insured loans after June 1991 are required to pay an annual insurance premium for up to the life of the loan, depending on loan type and the initial loan-to-value ratio of the loan. Borrowers who received FHA-insured loans between September 1983 and June 1991 were not required to pay annual mortgage insurance premiums.

that the Fund is actuarially sound. Instead, we believe that to determine actuarial soundness one should measure the Fund's ability to withstand certain worse-than-expected conditions. According to our estimates, worse-than-expected loan performance that could be brought on by moderately severe economic conditions would not cause the estimated value of the fund at the end of fiscal year 1999 to decline by more than 2 percent of insurance-in-force. Some more severe downturns that we analyzed also did not cause the estimated capital ratio to decline by as much as 2 percentage points. However, a few more severe economic scenarios could result in such poor loan performance that the estimated value of the fund at the end of fiscal year 1999 could decline by more than 2 percent of insurance-in-force.

To help determine the Fund's ability to withstand certain worse-than-expected conditions, we generated economic scenarios that were based on economic events in the last 25 years and other scenarios that could lead to worse-than-expected loan performance in the future. Under each of these scenarios, we used our models to estimate the economic value of the Fund and the related capital ratio (see table 2). Most of the scenarios we looked at had only a small impact on the capital ratio. For example, the worst historical scenario we tested, one based on the 1981-82 national recession, lowered the capital ratio by less than 0.4 percentage points—about 20 percent of the required 2 percent minimum capital ratio. To see how the economic value of the Fund would change as the extent of adversity increased, we extended regional scenarios that were based on historical economic downturns experienced in three states—the west south central downturn based on Louisiana in the late 1980s, the New England downturn based on Massachusetts in the late 1980s and early 1990s, and the Pacific downturn based on California in the 1990s—to the nation as a whole. In extending the west south central and Pacific downturns, the estimated capital ratio was about 1 percentage point lower than in the base case. However, our models estimate that extending the New England downturn to the country as a whole would reduce the capital ratio by almost 2.4 percentage points. In another scenario, in which we specify that interest rates fall substantially, inducing refinancing, and then a recession sets in, leading to increased foreclosures, the estimated capital ratio fell substantially, by over 1.8 percentage points.

In one other scenario, the capital ratio fell by over 2 percentage points. In that scenario we assumed that foreclosure rates in 2000 through 2004 equal foreclosure rates from 1986 through 1990 for mortgages originated in the 10-year periods prior to 2000 and 1986, respectively.

Table 2: Capital Ratios Under Expected and More Severe Economic Scenarios in Selected Locations

Scenario	Description	Capital ratio for scenarios in one region (percent)	Capital ratio for national scenarios (percent)
Expected economic conditions	Unemployment and interest rates vary as DRI forecasts; house price growth is adjusted for constant quality and slower growth[a]	NA	3.20
Historical regional downturns			
West south central downturn	House prices and unemployment rates change as they did in Louisiana from 1986 through 1990.	3.06	2.31
New England downturn	House prices and unemployment rates change as they did in Massachusetts from 1988 through 1992.	3.14	0.81
Pacific downturn	House prices and unemployment rates change as they did in California from 1991 through 1995.	2.89	2.16
Other national scenarios			
1981-82 Recession	For each state, house prices, unemployment rates, and interest rates change as they did from 1981 through 1985.	NA	2.81
Induced refinancing followed by a recession	Mortgage interest rates fall, inducing borrowers to refinance, and then a recession sets in, with a rising unemployment rate and falling house prices.	NA	1.37

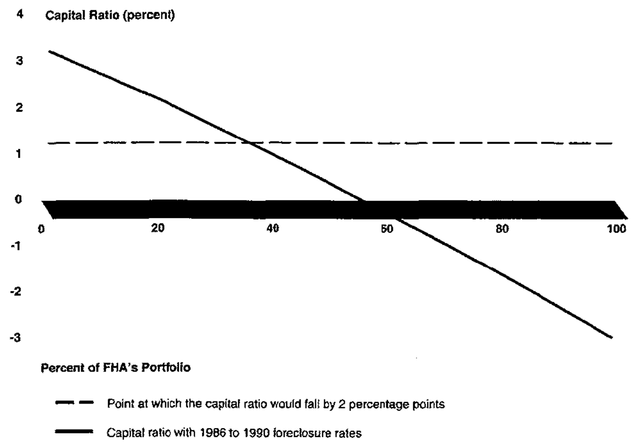
Rising interest rate scenario	Mortgage and other interest rates from 2000 through 2004 are higher than under expected economic conditions.	NA	3.36
Scenario with foreclosure rates from the 1980s	Foreclosure rates in 2000 through 2004 equal foreclosure rates from 1986 to 1990 for mortgages originated in most recent 10-year period.	NA	0.92

[a]Standard and Poor's DRI is a private economic forecasting company.

Source: GAO analysis.

Because none of our economic scenarios generated foreclosure rates as high as those experienced in the west south central states in the late 1980s, we applied these rates directly to our models, assuming that for the next 5 years foreclosure rates in most cases would be equivalent to those experienced by the west south central states in 1986 through 1990. Then we varied the proportion of FHA's portfolio experiencing these west south central foreclosure rates. As figure 3 shows, if about 36 percent of the portfolio experiences these rates, the estimated capital ratio would be 2 percentage points lower than the expected case; and if 55 percent of the portfolio experienced these rates, the economic value of the Fund would fall to zero.

Figure 3: Capital Ratios Resulting From Applying the Average 1986-90 Foreclosure Rates in the West South Central Census Division to Varying Proportions of FHA's Insurance Portfolio in 2000-04



Note: West south central mortgages made up 9 percent of FHA's portfolio in 1999. This analysis does not change foreclosure rates for streamline refinanced or adjustable rate mortgages because there are little data on these products for the 10-year period prior to 1986. The west south central Census division includes Arkansas, Louisiana, Oklahoma, and Texas.

Source: GAO analysis.

As we have stated in the past, there is considerable uncertainty associated with any estimate of the economic value of the Fund because of uncertainty about the performance of FHA's loan portfolio over the life of the existing loans, which, in some cases, can be for 30 years. We believe that our models make good use of historical experience in identifying the key factors that influence loan foreclosures and prepayments and estimating the relationships between those factors and loan performance. In addition, we have relied on reasonable, and in some cases conservative, forecasts of economic variables, such as the rate of house price appreciation and the unemployment rate, in finding that the Fund's economic value in fiscal year 1999 appeared higher than necessary to withstand many adverse economic scenarios.

Nonetheless, several additional factors lead us to believe that Congress and others should apply caution in concluding that the estimated value of the Fund today implies that the Fund could withstand the economic scenarios that we examined under all circumstances. Our estimates and those of others are valid only under a certain set of conditions, including that loans FHA insured in recent years and loans it insured in the more distant past have a similar response to economic conditions, and that cash inflows associated with future loans at least offset cash outflows associated with those loans. Some specific factors beyond those incorporated in our models that could determine the extent to which the Fund will be able to withstand adverse economic conditions are as follows:

- **The performance of recent loans**—Over 40 percent of FHA's loan portfolio at the end of fiscal year 1999 consisted of loans originated in fiscal years 1998 and 1999. As a result, the performance of these loans will have an important effect on the overall performance of FHA's loan portfolio. However, because these loans are so new, we do not have a lot of data yet showing how well they will perform over their lifetimes, which is often 30 years. Our model is based on data on loan performance for loans originating from 1975 through 1999. As long as the influences of key predictive factors on the probabilities of foreclosure and prepayment have not changed much over time, then we can be reasonably confident that the estimates of these relationships generated by our models will apply to these recent loans. However, in recent years, FHA's competitors in the conventional mortgage market—private mortgage insurers and conventional mortgage lenders—are increasingly offering to selected homebuyers products that compete with FHA's for those homebuyers who are borrowing more than 95 percent of the value of their homes. By lowering the required down payment, conventional mortgage lenders and private mortgage insurers may have attracted some less risky borrowers who might otherwise have insured their mortgages with FHA. And this may have increased the average risk of FHA-insured loans in the late 1990s. However, because these loans are relatively new, the increased risk would not yet be observable in the data on foreclosures and prepayments. If this effect, known as adverse selection, has been substantial, the economic value of the Fund may be lower than we estimate, and it may be more difficult for the Fund to withstand worse-than-expected loan performance than our estimates suggest.

- **Changes in FHA's insurance program**—A number of changes that FHA has made or might make in the future could affect the future cash flows associated with loans in FHA's portfolio as of the end of fiscal year 1999 and, therefore, the Fund's economic value, in ways that are not accounted for in our models. For example, if HUD reinstitutes paying distributive shares to borrowers when they pay their mortgages in full or voluntarily terminate their insurance, cash outflows might be higher than our estimates.[3] FHA's loss mitigation program might either reduce or increase cash outflows, depending on whether the program succeeds in reducing foreclosures or whether the program mainly results in delayed foreclosures that lead to larger losses for FHA in the long run. On the other hand, if FHA's financial counseling program reduces foreclosures for those homebuyers who received such counseling, then losses to the Fund will be less than we have estimated. Steps taken by HUD to improve the oversight of lenders and the disposition of properties could also reduce the level of losses to FHA below what we have estimated.

- **The impact of new loans**—Our models do not look at cash flows associated with loans that FHA would insure after fiscal year 1999. Our analysis of the ability of the Fund to withstand adverse economic conditions requires making the assumption that the adverse conditions would not also cause loans insured by FHA after fiscal year 1999 to be an economic drain on the Fund. Since the 1990 FHA reforms, the cash flows associated with each year's loans have been estimated to have a positive economic value, thereby adding to the economic value of the entire Fund. However, during adverse economic times, new loans might perform worse than loans that were insured by FHA during the 1990s. Furthermore, recent and future changes in FHA's insurance program may cause these loans to perform differently from how past experience suggests that they will. If, for example, FHA loosens underwriting standards, future loans may perform worse than past experience suggests. In addition, the recent reduction in up-front premiums could reduce cash inflows into the Fund, although it could also lower the riskiness of the loans that FHA insures. If the newly insured loans perform so poorly that they have a negative economic value, then the loss to the Fund in any of the adverse economic scenarios that we have considered would be greater than what we have estimated. Alternatively, if the newly issued loans have positive economic values, then they would contribute to further growth of the Fund.

[3] Between 1943 and 1990, FHA rebated these so-called excess funds to borrowers as distributive shares. In 1990, however, Congress suspended the payment of these shares until the Secretary of HUD determines that the Fund is actuarially sound. HUD has announced that it will resume paying distributive shares. HUD officials said that they are developing systems to facilitate the payment of these shares and expect to be ready to resume paying them in mid-2001.

Caution also needs to be applied in making changes to FHA's insurance program because of the current uncertainty about their impact on the Fund. In analyzing the impact of changes in FHA's programs and policies on the Fund, it is important to recognize that such changes can affect the volume and riskiness of loans that FHA insures. Although the models currently used in the annual actuarial reviews of the Fund can be used to estimate the direct impact that some policy changes may have on the Fund's economic value, these models cannot isolate indirect effects on the volume and riskiness of FHA's loans. Accordingly, in our report, we recommended that the Secretary of HUD develop better tools for assessing the impacts that these changes may have on the volume and riskiness of loans that it insures.[4]

Options for Drawing on the Fund Have Uncertain Outcomes, But Any Use of the Fund's Reserves Will Affect the Federal Budget

Given the recent growth in the economic value of the Fund, several proposals have been made to use what some are calling excess reserves or take other actions that could result in a change in the value of the Fund. If Congress or the Secretary of HUD believes that the economic value of the Fund is higher than the amount needed to ensure actuarial soundness, several changes to the FHA single-family loan program could be adopted. The impact that these actions might have on the capital ratio and FHA borrowers is difficult to assess without using tools designed to estimate the multiple impacts that policy changes often have. However, any actions that influence the Fund's reserve levels will also affect the federal budget. In short, any proposal that seeks to use reserves, if not accompanied by a reduction in other spending or an increase in receipts, would result in either a reduction in the surplus or an increase in any existing deficit.

Several changes to the FHA single-family loan program could be adopted if Congress or the Secretary of HUD believes that the economic value of the Fund is higher than the amount needed to meet its definition of actuarial soundness. For example, actions that the Secretary could take that could reduce the value of the Fund include lowering insurance premiums, adjusting underwriting standards, and reinstituting distributive shares. However, congressional action in the form of new legislation would be required to make other program changes that are not now authorized by the statute. These would include such actions as changing the maximum

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[4] *Mortgage Financing: FHA's Fund Has Grown, but Options for Drawing on the Fund Have Uncertain*

amount FHA-insured homebuyers may borrow relative to the price of the house they are purchasing and using the Fund's reserves for other federal programs.[5]

Reliably estimating the potential effect of various options on the Fund's capital ratio and FHA borrowers is difficult because the impacts of these policy changes are complex, and tools available for handling these complexities may not be adequate. Policy changes have not only immediate, straightforward impacts on the Fund and FHA's borrowers, they also have more indirect impacts that may intensify or offset the original effect. Implementing these options could affect both the volume and the average riskiness of loans made, which, in turn, could affect any future estimate of the Fund's economic value. As a result of this complexity, obtaining a reliable estimate would likely require that economic models be used to estimate the indirect effects of policy changes. At this time, however, neither the models used by HUD to assess the financial health of the Fund, nor those used by others, explicitly recognize the indirect effects of policy changes on the volume and riskiness of FHA's loans. As a result, HUD cannot reliably estimate the impact of policy changes on the Fund.

Although it is difficult to predict the overall impact of a change on the Fund's capital ratio and thus on FHA borrowers as a whole, different options would likely have different impacts on current and prospective FHA-insured borrowers. Some proposals would more likely benefit existing and future FHA-insured borrowers, while others would benefit only future borrowers, and still others would benefit neither of these groups. One interpretation of the higher premiums that borrowers paid during the period in which the economic value of the fund has been rising is that borrowers during the 1990s "overpaid" for their insurance. Some options for reducing the capital ratio, such as reinstituting distributive shares, would be more likely to compensate these borrowers. The payment of distributive shares would benefit certain existing borrowers who voluntarily terminate their mortgages. If these policies continued into the future, they would also benefit future policyholders. Alternatively, reducing up-front premiums, reducing the number of years over which annual insurance premiums must be paid, or relaxing underwriting standards would tend to benefit only future borrowers.

Outcomes (GAO-01-460, Feb. 28, 2001).

[5] During the 106th Congress, legislation was introduced that proposed using the Fund's resources to fund affordable rental housing (see S. 2997).

Under 1990 credit reform legislation, FHA's budget is required to reflect the subsidy cost to the government of FHA's loan insurance activities for that year.[6] Credit reform was intended to ensure that the full cost of credit activities for the current budget year would be reflected in the federal budget so that Congress and the executive branch could consider these costs when making annual budget decisions. For FHA's Mutual Mortgage Insurance Fund, the subsidy cost is negative; that is, the program is operating at a profit. Under credit reform, the negative subsidy receipts would be available for appropriation for other uses, and a balance would not be permitted to accumulate in the liquidating account. However, to accommodate the differing statutory requirements of budgeting for the subsidy cost of insuring the loans and maintaining a 2-percent reserve, the Office of Management and Budget (OMB) and FHA have allowed reserves to accumulate in the Fund in the form of interest-bearing Treasury securities. At the end of fiscal year 1999, FHA held nearly $15 billion in Treasury securities. These securities represent a claim on the U.S. Treasury to cover future losses to the Fund. From the perspective of the U.S. Treasury, these securities represent a liability. From the standpoint of the government as a whole, the securities represent a debt owed by one part of the federal government to another. By investing in nonmarketable Treasury securities, FHA makes funds available to other federal programs. Each year that the Fund runs a surplus, the budget surplus for the federal government, as a whole, is higher than it would otherwise have been if FHA had not been insuring profitable loans. When the total federal budget was in a deficit (as it was for most of the 1990s), that deficit was lower than it would have been if the Fund had not been realizing a surplus at the same time.

Because of the difficulty in reliably measuring the effect of most actions that could be taken either by Congress or the Secretary of HUD on the Fund's capital ratio, we cannot precisely measure the effect of these policies on the budget. However, any actions taken by Congress or the Secretary that influence the Fund's capital ratio will have a similar effect on the federal budget. If Congress or the Secretary of HUD adopts policies, such as lowering premiums, paying distributive shares, or loosening underwriting standards, that reduce the profitability of the Fund, the negative subsidy amount reported in FHA's budget submission and the Fund's reserve will both be lower.[7] Some of these policies—lowering premiums and paying distributive

[6]The subsidy cost is the estimated net cost to the government, in present value terms, of FHA-insured loans over the entire period the loans are outstanding.
[7]If Congress were to use the Fund's reserves to fund other programs, the reserves would be lower, but there would be no effect on the negative subsidy amount reported in FHA's budget submissions.

shares—would affect FHA's cash flows immediately.[8] Thus, the amount of money available for FHA to invest in Treasury securities would be lower. Treasury in turn would have less money available for other purposes, and the overall surplus would decline. If the amounts of cash flowing out of the Fund exceeded current receipts, FHA would be required to redeem its investments in Treasury securities to make the required payments. Assuming no changes in other spending and taxes, Treasury then would be required to either increase borrowing from the public or use general tax revenues to meet its financial obligations to FHA. In either case, the annual budget surplus would be lower.

Budgetary scoring for budget control purposes under the 1990 Budget Enforcement Act[9] is required only when a law is enacted; actions taken by the Secretary under existing authorities are not scored for budget control purposes, even though they may affect the budget surplus or deficit. Whether and how the proposals under discussion would be scored depend on the exact wording of the new law and is determined by OMB for Budget Enforcement Act purposes. However, any action taken by Congress or the administration to reduce FHA's reserves, if not accompanied by a similar reduction in other government spending or by an increase in receipts, will result in either a reduction in the surplus or an increase in any existing deficit.

Actuarial Soundness Should be Defined

Whether actions should be taken to change the value of the Fund depends on whether the Fund's capital resources and expected revenues exceed the amount needed to meet its expected cash outflows under designated stressful conditions; that is, whether it is actuarially sound. Assessing whether this condition exists requires that the degree of risk that the Fund is expected to be able to withstand must be specified. If the Fund is expected to withstand what Price Waterhouse called reasonably adverse economic downturns, then our results could be construed to mean that the Fund is taking in more revenue than it needs. Alternatively, if the Fund is expected to never exhaust its reserves, the current Fund might not be adequate.

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[8] Assuming that the volume and riskiness of FHA-insured loans will not change, HUD estimates that the recent reductions in up-front premiums combined with the introduction of mortgage insurance cancellation policies will lower the estimated value of the Fund by almost $6 billion over the next 6 years.

[9] As part of the effort to control federal budget results, the Budget Enforcement Act of 1990, as amended, created controls over laws changing or creating mandatory spending (basically entitlements) and receipts.

The 1990 reforms did not specify the amount of risk that the Fund needed to withstand. Instead, the reforms specified a minimum capital ratio and required that the Fund achieve actuarial soundness before the secretary of HUD could take certain actions that might reduce the value of the Fund. Because we believe that actuarial soundness depends on a variety of factors that could vary over time, setting a minimum or target capital ratio will not guarantee that the Fund will be actuarially sound over time. For example, if the Fund comprised primarily seasoned loans with known characteristics, a capital ratio below the current 2-percent minimum might be adequate. But under conditions such as those that prevail today, when the Fund is composed of many new loans, a 2-percent ratio might be inadequate if recent and future loans perform considerably worse than expected.

We believe that to evaluate the actuarial soundness of the Fund, one or more scenarios that the Fund is to withstand would need to be specified. Then it would be appropriate to calculate the economic value of the Fund or the capital ratio under the scenario(s). As long as the estimated economic value of the Fund is positive when the desired stress scenario(s) is used to make that estimate, the Fund could be said to be actuarially sound. However, it might be appropriate to leave a cushion to account for the factors not captured by the model and the inherent uncertainty attached to any forecast. In any event, we believe that a single, static capital ratio does not measure actuarial soundness.

Matters for Congressional Consideration

For these reasons, Madam Chairwoman, Congress may wish to consider taking action to specify criteria for determining when the Fund is actuarially sound. More specifically, Congress may want to consider defining the types of economic conditions under which the Fund would be expected to meet its commitments without borrowing from the Treasury.

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Madam Chairwoman, this concludes my statement. We would be pleased to respond to any questions that you or Members of the Subcommittee may have.

Related GAO Products

Mortgage Financing: FHA's Fund Has Grown, but Options for Drawing on the Fund Have Uncertain Outcomes (GAO-01-460, Feb. 28, 2001).

Mortgage Financing: Financial Health of the Federal Housing Administration's Mutual Mortgage Insurance Fund (GAO/T-RCED-00-287, Sept. 12, 2000).

Mortgage Financing: Level of Annual Premiums That Place a Ceiling on Distributions to FHA Policyholders (GAO/RCED-00-280R, Sept. 8, 2000).

Single-Family Housing: Stronger Measures Needed to Encourage Better Performance by Management and Marketing Contractors (GAO/T-RCED-00-180, May 16, 2000, and GAO/RCED-00-117, May 12, 2000).

Single-Family Housing: Stronger Oversight of FHA Lenders Could Reduce HUD's Insurance Risk (GAO/RCED-00-112, Apr. 28, 2000).

Homeownership: Information on Single-Family Loans Sold by HUD (GAO/RCED-99-145, June 15, 1999).

Homeownership: Achievements of and Challenges Faced by FHA's Single-Family Mortgage Insurance Program (GAO/T-RCED-98-217, June 2, 1998).

Homeownership: Results of and Challenges Faced by FHA's Single-Family Mortgage Insurance Program (GAO/T-RCED-99-133, Mar. 25, 1999).

Homeownership: Management Challenges Facing FHA's Single-Family Housing Operations (GAO/T-RCED-98-121, Apr. 1, 1998).

Homeownership: Information on Foreclosed FHA-Insured Loans and HUD-Owned Properties in Six Cities (GAO/RCED-98-2, Oct. 8, 1997).

Homeownership: Potential Effects of Reducing FHA's Insurance Coverage for Home Mortgages (GAO/RCED-97-93, May 1, 1997).

Homeownership: FHA's Role in Helping People Obtain Home Mortgages (GAO/RCED-96-123, Aug. 13, 1996).

Mortgage Financing: FHA Has Achieved Its Home Mortgage Capital Reserve Target (GAO/RCED-96-50, Apr. 12, 1996).

Homeownership: Mixed Results and High Costs Raise Concerns about HUD's Mortgage Assignment Program (GAO/RCED-96-2, Oct. 18, 1995).

Mortgage Financing: Financial Health of FHA's Home Mortgage Insurance Program Has Improved (GAO/RCED-95-20, Oct. 18, 1994).

Responses to Questions from Chair Marge Roukema

1A. On page 1 of your testimony, you clearly state that the current housing laws do not define actuarial soundness, nor is it defined in the actuarial profession. Yet, the Mutual Mortgage Insurance Fund (Fund) is required to be sound. What would you consider an effective measurement tool to gauge the soundness of the Fund?

We believe that the best measure of the actuarial soundness of the Fund is its ability to withstand certain worse-than-expected loan performance. Ideally, the Congress and/or HUD would specify economic scenarios under which the Fund would be expected to meet its commitments without borrowing from the Treasury. The specification of these scenarios should vary the level, duration, and scope of house price appreciation, unemployment, and interest rates—key economic factors that are associated with loan performance. The scenarios may be based on adverse historical experience as well as conditions that are plausible given current conditions. In addition, scenarios should consider various timeframes and the possibility that multiple adverse events can occur in close proximity over time.

Once the criteria for actuarial soundness are specified, economic and cash flow models are tools that could be used to estimate the impact that these conditions might have on the net present value of the Fund and the related capital ratio. The economic model should specify the key economic factors that are associated with loan performance as measured by foreclosure and prepayment rates. Such a model would also need to account for geographic differences in FHA's market concentration, particularly given that regional economic downturns are more likely than are national downturns, and that changes in house values are more pronounced when measured on a regional level. Finally, this model would need to be able to estimate foreclosure and prepayment rates under fairly extreme conditions, such as those that the Fund experienced during the 1980s, when the nation had high interest rates, a national recession, and several regional downturns. The economic model would be used to estimate future foreclosure and prepayment rates under the specified adverse scenarios. These rates would then be used in a cash flow model to estimate the value of the Fund and the related capital ratio. Alternatively, but less ideally, worse-than-expected loan performance as measured by foreclosure and prepayment rates could be used directly in a cash flow model to estimate the value of the Fund under adverse conditions. Again, a variety of combinations of foreclosures and prepayments should be considered and timeframes and the characteristics of the loan portfolio should be varied.

1B. With two years of study, have you produced a model that could verify each year the measurements provided by FHA on the capital ratio standards?

Our model could serve to provide independent estimates of the value of the Fund and the related capital ratio. However, producing these estimates would require annual investments to update both the econometric and cash flow models. In the past, we used a similar model to provide the Congress with independent estimates of the Fund's value and capital ratio. However, because these independent estimates were close to the estimates prepared by Price Waterhouse, we reached agreement with our congressional requestors to discontinue preparing annual estimates after preparing the fiscal year 1994 estimate. Starting in 1999, HUD contracted with Deloitte & Touche to prepare the annual actuarial review. Although we did not evaluate the quality of Deloitte's estimates, we believe that Deloitte's and our estimates for 1999 are comparable, given the uncertainty inherent in forecasting and the number of professional judgments made in this type of analysis.

1C. Do you believe there could be more than one capital ratio requirement? If so, what recommendations could you provide to structure that multi-layered capital ratio requirement?

We believe that a single, static capital ratio would not provide an accurate measure of actuarial soundness. To evaluate the actuarial soundness of the Fund, one or more scenarios that the Fund must withstand would need to be specified. The economic value of the Fund under the specified scenario(s) would then need to be calculated in order to determine the appropriate capital ratio(s). As long as the estimated economic value of the Fund is positive when the desired stress scenario(s) is used to make that estimate, the Fund could be said to be actuarially sound. In addition, it might be appropriate to have an additional cushion to account for factors not captured by the model that might influence the Fund's economic value and the inherent uncertainty attached to any forecast. Therefore, we believe that, in addition to a minimum capital ratio, the Congress may wish to consider specifying the economic conditions that it expects the Fund to withstand.

Members of Congress and HUD officials have suggested that a capital ratio of 3 percent might represent actuarial soundness. While a capital ratio of 3 percent seems sufficient at this time to cover many adverse economic conditions, the amount needed to cover reasonably adverse scenarios would need to be reevaluated over time as current economic conditions, HUD policies, conventional mortgage market activity, and the composition of the insured portfolio vary.

1D. Your recommendations suggest that Congress specify certain conditions. What are your recommendations on the various types of economic conditions?

As noted above, the conditions that the Congress may specify for determining when the Fund is actuarially sound could be derived from historical experiences which are modeled separately, in combination, or in sequence; and from reasonably plausible alternative scenarios. The scenarios would be defined in terms of key economic variables that affect foreclosure rates and prepayment rates , or by specifying foreclosure and prepayment rates directly. As an example, economic scenarios could be specified to include a time period of specific duration in which an economic downturn of a specific severity and scope affected the performance of FHA's portfolio. Alternatively, a foreclosure scenario could be specified that includes a time period of specific duration in which FHA loans experienced high foreclosure rates. In fact, our recent report includes such scenarios, some of which resulted in a decline in the estimated value of the Fund that exceeded 2 percentage points. One could also specify scenarios that include changes in key economic variables that, while not based on history, are nonetheless plausible. Such scenarios could specify reductions in house prices, increases in unemployment, and changes in interest rates. In fact, our report includes an interest rate scenario in which rising interest rates followed by an economic downturn result in the value of the Fund declining by nearly 2 percent. The likelihood of any scenario may not be specified with any precision, regardless of whether it is based on historical experience.

1E. Would it be irresponsible for Congress to not require a ratio that must cover catastrophic conditions?

Because of FHA's mission, requiring the capital ratio to cover catastrophic conditions may be inappropriate. Substantial financial and social consequences are inherent in any policy changes that affect the characteristics of borrowers that the Fund insures. Requiring, for example, that FHA borrowers pay higher premiums or downpayments could improve the Fund's actuarial soundness, but some potential FHA borrowers may no longer be eligible for loans, thus causing them to delay their home purchases or forego them altogether. Thus, in the past we have suggested that the Congress carefully balance desires to assist homebuyers with its expectations of the housing market's future performance, and the federal government's potential financial risk.. In its original 1990 study of the Fund, Price Waterhouse, now PricewaterhouseCoopers, suggested that it would be inappropriate to require that the Fund hold enough reserves to cover catastrophic conditions. Price Waterhouse also said that to require a ratio that high would prohibit FHA from meeting its social goals of providing opportunities for home ownership to those individuals most in need of its services. Price Waterhouse also stated that catastrophic risk is implicitly covered through the backing of the U.S. Treasury.

2. The private sector also provides mortgage insurance to borrowers who have insufficient equity in their homes or, in some cases, less than sterling credit. Who regulates the private sector and how does FHA compare to these private companies in terms of capital reserve requirements?

States regulate private mortgage insurance companies. Generally, the states require mortgage insurers to hold 4 percent of their insurance in force in reserve. However, there are various kinds of reserves, and after loans perform adequately for a certain number of years some of these funds may be released. In addition to state requirements, rating agencies rate the credit quality of private mortgage insurers. Without a minimum rating, private mortgage insurers would be unable to attract capital from the financial markets or parent organizations. The rating agencies do not require a given level of reserves. Instead, they require that the insurers pass a stress test based on the experiences of the southwest central states during the 1980s. The rating depends on the amount of capital that the insurer is estimated to have after subjecting its portfolio to loan performance similar to that experienced in the southwest central states during the 1980s.

3A. As you are aware, the HUD Secretary is authorized to rebate premiums to borrowers who prepaid their mortgages. Many Members and staff misunderstand that concept of a premium rebate. Please explain the authority the Secretary has to rebate premiums, who is eligible and what impact, if any, the Secretary should know it will have on the Fund?

Currently there are two different types of insurance premiums paid by FHA borrowers. The first is an up-front premium, which is paid at the time that the loan is originated and is usually financed as part of the mortgage. The second is an annual premium of .5 percent of the outstanding loan balance, one twelfth of which is paid monthly to the lender. Generally, FHA borrowers who pay off their mortgage within 7 years (5 years for loans originated this year[1]) are eligible to receive a refund of a portion of the up-front insurance premium regardless of the actuarial status of the Fund. In contrast, up until 1990, HUD also paid distributive shares (what some have called rebates) to homeowners who voluntarily terminated their mortgages by paying off the mortgage on time, or early, such as when refinancing their loan or selling their house. The amount of any such payment is limited to the amount of the annual premium the homeowner had paid over the life of the mortgage. In 1990, after the Fund began experiencing substantial losses, the Congress required FHA to stop paying distributive shares until the Fund attained actuarial soundness. Thus, in determining whether there is a surplus for distributing to borrowers, the Secretary must now take into account the actuarial status of the entire Fund. Last year, HUD announced that it would begin paying distributive shares in mid-2001.

In the past, FHA borrowers were considered eligible for distributive shares if they voluntarily terminated their mortgages after holding them for at least 7 years, had paid annual insurance premiums, and had their loans originated in years that produced a cohort of mortgages that was profitable.[2] In September 2000, we reported that between 132,508 and 186,032 FHA borrowers who had voluntarily terminated their mortgages in fiscal year 1999 might have been eligible for distributive shares if FHA had paid such shares under the rules that existed prior to 1990. The total annual premiums paid by these borrowers was between $271 million and $395 million.

3B. Does it make sense, in this case, to rebate insurance premiums where the income (premiums) far outpaces the program's costs?

Once the Fund is determined to be actuarially sound, the Secretary may resume the payment of distributive shares. However, the Secretary need not limit payment of distributive shares only to borrowers that terminated their loans after 7 years and that

[1] As with other types of insurance (auto, life, etc.), an up-front insurance premium is considered unearned until enough time has passed to expose the endorsing insurance company to the amount of risk that is covered by the up-front premium. For loans insured by FHA this year, FHA considers the up-front insurance premium to be completely earned after 5 years have passed.

[2] Because the risk of an insurance claim is usually the greatest during the first 7 years of a mortgage, FHA will most likely not pay distributive shares to borrowers who terminate their loans within 7 years of receiving them.

had their loans originated in a year that produced profitable loans, as was the practice in the past.

The FHA mortgage insurance Fund was established as a "Mutual Mortgage Insurance Fund." Under the concept of mutuality, FHA borrowers would receive distributions or dividends of Fund surpluses. In practice FHA borrowers that had their loans originated in years that produced profitable loans were paid dividends in the form of distributive shares once they voluntarily terminated their loans. In contrast, borrowers that had loans originated in years that did not produce profitable loans were ineligible for distributive shares. As a result, distributive shares were sometimes paid to one group of borrowers, while the Fund lost money on other groups of borrowers. Paying distributive shares allows FHA to determine what is an appropriate premium after knowing the performance of the loans, which would enable FHA to treat borrowers equitably. However, the concept of mutuality also means that some premiums paid by some borrowers cross-subsidize other borrowers, whose loans were not profitable. In the 1990 reforms, the Congress required that the Secretary consider the actuarial soundness of the entire Fund in determining whether to make distributive shares. The Congress could help the Secretary in determining the actuarial soundness of the Fund by specifying the economic conditions that it expects the Fund to withstand.

4. What factors do you believe accounted for an "excessive reserve"?

The Fund's economic value principally reflects the large amount of capital resources that the Fund has accrued. Because current capital resources are the result of previous cash flows, the robustness of the economy and the higher premium rates throughout most of the 1990s accounted for the accumulation of these substantial capital resources. Good economic times that are accompanied by relatively low interest rates, relatively high levels of employment, and rising house prices are usually associated with high levels of mortgage activity and relatively low levels of foreclosure; therefore, cash inflows have been high relative to cash outflows during this period. The question of what level of reserves could be considered excessive is one for the Congress to answer. The Congress could do this by defining the type of economic conditions under which the Fund would be expected to be actuarially sound.

5A. Recent news reports suggest that FHA is experiencing higher than normal foreclosures and defaults. In fact, in one report, 30-day delinquencies reached 10.46% versus 3.4% for non-FHA insured mortgages. What is the cause of a higher rate of FHA defaults? If these trends continue, how soon could reach a point where we meet one of the three economic scenarios that the 2% capital ratio requirement is insufficient to cover?

Mortgages are considered delinquent when a borrower fails to make timely mortgage payments. These are sometimes measured in 30, 60 and 90-day increments. If a borrower continues to be delinquent the mortgage is characterized as being in default and the foreclosure process begins. A foreclosure occurs when the lender terminates the mortgage contract and the borrower loses the home. However, not all defaulting FHA mortgages end in foreclosures. According to HUD, most delinquent loans are reinstated as good performing loans.

Although delinquency and foreclosure rates are given much publicity, these numbers should be interpreted with caution. Foreclosure rates differ according to the number of years a loan is outstanding. It is more meaningful to look at these rates on a book-of-business basis. For example, loans that ultimately go to foreclosure usually do so in years 4 through 7. If a high proportion of the portfolio consists of loans that are in their peak foreclosure years, the delinquency/foreclosure rates for the entire portfolio may appear high. We did not see a clear trend in the annual conditional claim rates for FHA loans insured from 1990 through 1999.

The current foreclosure rates would have to increase substantially before they reach the levels that are consistent with the three scenarios in which we estimate a decline of greater than 2 percent of the value of the Fund. For example, in one of the three scenarios in which we estimate that the Fund's economic value would be two percent lower than under expected conditions, we apply foreclosure rates in 2000 through 2004 that are equal to foreclosure rates from 1986 to 1990 for mortgages originated in the most recent 10-year period. The average estimated ultimate foreclosure rate for loans originated during 1976 through 1985 was 13.6 percent. In contrast, the average ultimate foreclosure rate for loans originated during 1990 through 1999 is estimated to be 5.2 percent.

6. On page 13 of your testimony, you state that " under credit reform, the negative subsidy receipts would be available for appropriation for other uses, and a balance would not be permitted to accumulate in the liquidating account. Yet, you state that the reserves are being used to fund other parts of the Federal government., Could you explain your understanding of the relationship between the Fund reserves and the rest of the Federal government? Do you agree with CBO that these funds are not isolated and identifiable for specific programs?

Our understanding of the relationship between the Fund's reserves and the rest of the federal government is as follows. Each budget year FHA receives cash receipts from the public, largely from premium income and the sale of foreclosed homes. Generally, the receipts not used to pay claims represent FHA's annual negative subsidy estimate. These funds are lent to the Treasury by investing them in interest-bearing U.S. Treasury securities. The receipts that have been borrowed from FHA are then general receipts to the federal government and are available to be appropriated for all federal programs, including housing. Thus, by investing in Treasury securities, FHA makes funds available to other federal programs. If these funds are not appropriated to be spent on government programs or used for a tax cut they increase the budget surplus. Each year that the Fund runs a surplus, the budget surplus for the federal government, as a whole, is higher than it would have been if FHA had not been insuring profitable loans. When the total federal government was in a deficit (as it was for most of the 1990s), that deficit was lower than it would have been if the Fund had not been realizing a surplus at the same time.

As stated in our testimony, under credit reform, negative subsidy receipts would normally be available for appropriation for government uses, and a balance would not be permitted to accumulate in the liquidating account in the form of non-marketable Treasury securities, as noted above. However, because FHA is required to maintain a 2-percent capital reserve, an agreement was struck between FHA and OMB that allows FHA's negative credit receipts to accumulate in its liquidating account. In terms of the effect on the budget, the only substantial difference between FHA and other federal credit programs with negative subsidies is that FHA is allowed to hold Treasury securities in the liquidating account. These securities represent the sum of past negative credit subsidies. However, the negative receipts reported by FHA and other credit programs each year are all available as general receipts to be spent on federal programs. In this regard, we agree with CBO that these annual negative subsidy receipts are not isolated and identifiable for specific programs.

7. *While conducting your study, what FHA single family programs could you identify that would contribute to the deterioration of the Fund? Is the FHA Adjustable Rate Mortgage program in high default and to what proportion does it absorb capital reserves? What about streamlined refinances—will they impact the Fund?*

The extent to which different loan products contribute to the health of the Fund depends on the performance of these products (prepayment and claim rates), the proportion of the portfolio that these products comprise, and the premiums received. For example, FHA's adjustable-rate mortgages (ARMs) have higher foreclosure rates than do its 30-year fixed-rate mortgages for the same books of business. Streamline refinance loans have even lower foreclosure rates. FHA insures far more 30-year fixed rate mortgages than it insures ARMs or streamline refinance loans. Premiums are the same for ARMs and 30-year fixed-rate mortgages, but streamline refinance loans had lower up-front mortgage insurance premiums, and in the past required fewer years of annual premiums. Consequently, while it is reasonable to conclude that 30-year fixed-rate mortgages have contributed more toward the health of the Fund than have ARMs, the relative contribution of streamline refinance loans is less clear. That is, if the reduction in claim payments of streamline refinanced loans exceed the reduction in premium income, the Fund will benefit from these loans. If, however, the reduction in premium income from streamline refinance loans exceeds the reduction in claim payments, the Fund benefits less from these loans. However, the alternative to streamline refinances is likely to be that stronger FHA borrowers refinance their loans elsewhere, and this would have a negative impact on the Fund.

Because of higher than normal default and foreclosure rates on ARMs, the FHA took steps to limit the number of ARMs it insures. In fact, while about 30 percent of loans that FHA insured during 1997 were ARMs, only about ten percent of the loans FHA insured the following year were ARMs. At the same time, streamline refinance loans represented a larger share of originations in 1998 and 1999. In 1999—during a time of low interest rates–almost a quarter of loans FHA insured were streamline refinance loans.

8. What additional analysis would you recommend Congress propose in this area and why?

In our report, we recommend that the Secretary of HUD develop better tools for assessing the impact that policy changes may have on the volume and riskiness of loans that FHA insures. Such analysis is particularly important where the policy change permanently affects certain loans, as in the case of underwriting and premium changes. The Congress could propose that FHA improve its capability for modeling the demand for FHA mortgage insurance. At present, FHA's modeling of mortgage demand assumes that FHA's share of the mortgage market does not change with changes in FHA's product. Improvements to FHA's demand model would help FHA in assessing the full impact that policy changes may have on the Fund. The Congress also may wish to propose that FHA provide additional analysis of the default and foreclosure experience of FHA loans by various measures including loan type, loan-to-value ratio, location, and year of origination. Such analysis would allow the Congress to better understand differences in the riskiness of FHA-insured loans, and the reasons for changes in the Fund's economic value.

Responses to Questions from Rep. John LaFalce:

1. Having concluded that even under "more severe economic scenarios" the FHA Fund balance will not be depleted, GAO then apparently tried to identify under what economic circumstances the Fund be depleted. Using the approach of applying 1986-1990 loss rates in the West South Central Census Division nationwide, GAO apparently arrived at a calculation that if such loss rates were extended to 55 percent of the nation, the Fund would be depleted. How likely is that scenario? Put in perspective, would other major financial institutions – including banks, for example whose deposits are insured by the federal government – also be at risk of failure in such an economic scenario?

It is not possible to precisely measure the likelihood that 55 percent of FHA's portfolio experiences foreclosure rates like those experienced in the West South Central Census Division. Nonetheless, the three Census Divisions (there are 9 Census Divisions) where FHA insures the greatest number of loans make up 56 percent of FHA's portfolio. It is less likely that a regional downturn of this severity would affect three Census Divisions simultaneously than it is to affect a single Census Division. Nonetheless, some of the less likely events may have the greatest impact on the Fund. For example, while the combination of events that depleted the Fund during the 1980s occur less frequently than downturns in single Census Divisions, the negative impact on the Fund was substantial. By 1990, the Fund had a negative value. The negative impact on the Savings and Loan industry during the 1980s was also substantial. At the time that the scale of S&L losses were mounting, the Congress passes the FHA reforms requiring that the Fund be actuarially sound, and establishing a minimum capital ratio requirement. Should foreclosures reach a point where the Fund had a negative value, the federal government would be obligated to pay any additional claims, regardless of the performance of other financial institutions. Given the actions taken in response to the S&L crisis and the performance of the FHA, it is not unreasonable to expect that the federal government would address failures of major financial institutions at the same time that it would address any shortfalls in the Fund.

2. FHA's Capital Ratio calculation uses as a denominator "unamortized insurance-in-force," which refers to the original principal balances of the portfolio of insured loans. Since FHA and the federal government bear no risk for the already amortized portion of a loan, wouldn't a more accurate ratio use "amortized insurance in force?

Because FHA-insured 30-year mortgages are in fact fully amortized over the 30-year life of the loans, the amortized insurance-in-force represents a better measure of the Fund's potential liability. However, data on unamortized insurance-in-force are considered more accurate than data on amortized insurance-in-force. That is, FHA does not maintain data on actual principal payments made by FHA borrowers, and therefore the estimate for amortized insurance-in-force is likely to be different than the actual amount. As we noted in the report, the Omnibus Budget Reconciliation Act of 1990 defined the capital ratio as the ratio of the Fund's capital, or economic net worth, to its unamortized insurance-in-force. However, the act defined unamortized insurance-in-force as the remaining obligation on outstanding mortgages—a definition generally understood to apply to amortized insurance-in-force. According to a former Assistant Secretary for Policy Development and Research, had the Congress intended that the capital ratio be measured using amortized insurance-in-force, the minimum capital ratio would have been higher than 2 percent. Nonetheless, the difference in the values of unamortized and amortized insurance-in-force is not great today because many FHA-insured loans were made in the last two years. Specifically, we calculated that the unamortized insurance-in-force at the end of fiscal year 1999 was about $494 billion and estimated that the amortized value of that insurance was $456 billion. Therefore, the economic value of the Fund represented 3.20 percent of the unamortized insurance-in-force and about 3.47 percent of the amortized insurance-in-force on September 30, 1999.

STATEMENT OF
SUSAN GAFFNEY, INSPECTOR GENERAL
DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
BEFORE THE HOUSE SUBCOMMITTEE ON
HOUSING AND COMMUNITY OPPORTUNITY
MARCH 20, 2001

Chairman Roukema and other members of the Subcommittee, it is my pleasure to testify before you on the Inspector General's perspective on the health of the Federal Housing Administration's (FHA's) Mutual Mortgage Insurance (MMI) Fund. Accompanying me is James Heist, Assistant Inspector General for Audit.

Your other witnesses today can better answer technical questions about the economic value of the MMI fund, what capital reserve level is needed, and, most importantly, what these figures mean in terms of the future health of the MMI fund. I will defer to them to make assumptions about the future economic performance of the MMI fund. Other than pointing out two factors that need to be included in making such assumptions, I will be talking about Office of Inspector General (OIG) audit and investigation work in the Single Family Mortgage Insurance Program.

Need to Consider the Impact of Premium Changes and Loss Mitigation on the MMI Fund

One reason for the financial health of the MMI Fund has been the high insurance premium structure for FHA mortgages. Prior to 1983, the FHA Mortgage Insurance Premium was an annual charge of ½% of the outstanding mortgage principal balance. Today, FHA collects both up front and annual premiums. Until recently, most FHA loans included a 2.25% up front premium charge as well as an annual premium of ½% of the outstanding mortgage principal balance. Effective January 1st of this year, the up front premium dropped by a third to 1.50%, and significant changes were made to premium refund and cancellation policy. In fiscal year 2000, the FHA MMI fund's earned premium revenue was $ 2,886 million. Unless there is a corresponding growth in FHA activity, this recent change in the premium structure will have a major impact on future revenue earnings of the MMI fund.

Another reason for the current health of the MMI fund is the increased use of foreclosure avoidance techniques. Two years ago we performed an audit of HUD's Loss Mitigation Program. We noted that the use of loss mitigation tools by lenders was growing exponentially. However, because of the newness of the program, there was no way for us to tell if the tools were working as intended. That is, did the use of the loss mitigation tool, such as restructuring the mortgage through a loan modification, actually have the intended effect of preventing the borrower from going into foreclosure? Or, did the loss mitigation merely delay the foreclosure process? We will be looking to answer these questions in an audit scheduled to start later this year. GAO's report makes this same observation. If we find the program is not mitigating foreclosures, the future impact on the MMI fund in terms of future claims will be significant.

FHA Financial Audit

Earlier this month, we issued our report based on KPMG LLP's audit of the Federal Housing Administrations financial statements for the year ended September 30, 2000. KPMG expressed an unqualified opinion on these financial statements. However, KPMG also reported a potential non-compliance with the Anti-Deficiency Act, 31 U.S.C. 1341 (a), that requires additional analysis, as well as a policy or legal determination by HUD's Office of General Counsel, OMB and/or the Comptroller General. The report identifies a material weakness and three reportable conditions on internal controls. The material weakness involves the need for FHA to improve information technology systems to better support business processes. The reportable conditions include the need for: enhanced security over data, improved progress on early warning / loss prevention activities and better monitoring and accounting for single-family property inventories.

While the same material weakness and reportable conditions were included in FHA's fiscal year 1999 audit, we are seeing progress in each of these areas. Also, one material weakness and three reportable conditions reported in fiscal year 1999 are no longer being reported in fiscal year 2000. However, the fiscal year 2000 financial audit recognizes that the impact of the single-family fraud being reported by the OIG could be recognized as unexpected future claims and defaults against FHA's funds.

Summary of OIG Audit and Investigative Work

Aside from the financial audit, in the last few years our audit and investigative staffs have been actively involved in examining many aspects of the FHA single-family operations. We've identified origination frauds, property flipping scams and scandals in the sale of HUD owned properties. Needless to say, all these problems have an impact on the soundness of the MMI Fund. There are many factors beyond HUD's control—such as interest rates and unemployment rate--that affect the soundness of the MMI Fund. But assuring that programs are run efficiently and effectively and that programs are sufficiently managed to minimize the opportunities for fraud and abuse is within HUD's control.

As a result of a robust economy, FHA's MMI fund is financially the healthiest it has been in many years. But just because the FHA fund is profitable is no reason to tolerate program fraud. There are always opportunities to make things better. The FHA is a national treasure, built on a solid foundation. For more than 65 years, this government program has helped real people meet their dream of homeownership. For many first time homebuyers with little or no credit history or for those unable to make large down payments, it was the FHA that made their dream possible. The FHA has a great reputation and many people look at FHA as the government's "seal of approval". Accordingly, we find it scandalous when program abuses result in defaults and foreclosures, harming the very people that the FHA program was designed to help.

While the present health of the fund is important, its long-term financial health is critical. FHA should take heed of the many warning indicators we see in our audits and investigations. It is important to keep in mind that a defaulted or foreclosed FHA insured mortgage resulting from poor origination practices that is originated today would take several years before it results in an FHA claim. Conversely, program improvements made today will take several years before they result in reductions in defaults and claims.

Problems Impacting the Financial Health of the MMI Fund

Flipping- Property flipping has become an increasing problem for the FHA. With flipped properties the MMI fund often gets saddled with insurance on an overvalued property. There's nothing inherently wrong with an entrepreneur buying a fixer upper property, making repairs and reselling it at a profit. What makes a property flip illegal is when there is something amiss in the transaction. When we see properties with FHA mortgage insurance bought and sold the same day for a 50% or 100% profit, we can be reasonably certain that something is wrong. In most cases, the profit results from false and fraudulent documentation provided by one or more of the parties to the transaction, such as the lender and/or the appraiser. In almost every case where we've seen a property flip, that is, a wide disparity between the purchase price and the resale price of a property, and a short turnaround between the two transactions—something illegal has happened. Unfortunately, these flips feed on each other, as the inflated value of one flipped property often becomes the valuation measure for the next property. Before long, these transactions have a devastating effect on neighborhoods.

We have numerous ongoing investigations involving single-family loan origination fraud, and specifically property flipping, throughout the United States. In our Housing Fraud Initiative locations, such as New York, Baltimore, Chicago, and Los Angeles, massive property flipping schemes involving FHA-insured mortgages continue to be uncovered. Flipping is increasing and has become a major problem for many communities. What is similar about these communities is the high volume of older decaying properties and an eager group of potential, often unsophisticated, low-income buyers who are anxious to achieve the American Dream of home ownership. In many cases we find that their dream of home ownership ultimately turns into a nightmare as their property begins to need major repairs and they discovers that their property's real value is only a fraction of its original purchase price.

Last fall, in the Central District of California, we had one of our largest convictions for property flipping. Two co-conspirators were sentenced to a total of 134 months imprisonment, fined $100,000, and ordered to make over $2.6 million in restitution. The real estate scheme included duping more than 15 high school and college students, with previously clean credit records, into becoming buyers of flipped properties. The kingpin of this flipping scheme purchased at least 30 properties in the range of $80,000 to $100,000 each and then resold them at inflated prices of $200,000 to $300,000 each. These cases involved the use of forged documents to qualify the buyers for FHA insurance. Some additional properties were sold conventionally. To date, 28 FHA insured loans totaling over $6,500,000 have gone into foreclosure. Six other defendants in this case have also signed plea agreements.

Early last year in Baltimore, Maryland, a property speculator, two loan originators, an appraiser and a settlement attorney were indicted for engaging in a prolific scheme to acquire inexpensive homes and fraudulently qualify buyers to purchase the properties at much higher prices. The vast majority of over 100 settlement statements for the purchase of these properties contained false information about the buyers' and sellers' monetary contributions to the transactions. Appraisals often overstated property values and misrepresented ownership at the time of the sale. Flipping was so prevalent in Baltimore that HUD put a moratorium on foreclosures.

Last June in Fort Lauderdale, Florida, a Federal grand jury returned an 11 count Indictment charging seven individuals with conspiracy to commit bank fraud, HUD fraud and false statements on more than 120 loan applications, most of them FHA-insured, totaling in excess of $15 million dollars. The mortgage fraud was predicated on a flipping scheme. A real estate investor would purchase homes and, on the same day, resell them at inflated prices to unqualified buyers he had recruited. The buyers of these properties—almost always unsophisticated, first time home buyers and/or recent immigrants--did not have sufficient income or assets to pay the required down payment and closing costs, so the investor would illegally provide funds to them and incorporate these costs into the price of the over-inflated loans. A variety of fraudulent documents were used to make it appear that the buyers qualified for the loans.

Lender Oversight- A comprehensive audit of FHA loan origination practices issued early last year found significant problems with FHA's reviews of lender underwriting and property appraisals. Also, the monitoring of lenders by HUD's Quality Assurance Division was deficient. We noted problems with the oversight of pre-endorsement contractors, and the accuracy of information in the automated tracking system. These weaknesses increase HUD's risk of losses and can result in inflated appraisals, fraudulent underwriting, property flipping and other lending abuses. HUD's procedures for monitoring both lenders and contractors were less than effective, resulting in an increased risk of fraud, waste and abuse.

HUD's mortgage insurance risk depends almost exclusively on the reliability of work performed by its direct endorsement (DE) lenders that underwrite nearly all FHA insurance. HUD mitigates its risk through lender oversight. Three important HUD monitoring tools should be working to prevent the insurance of fraudulent loans: post endorsement technical reviews of loan underwriting documentation, field reviews of appraisals, and quality assurance reviews of lenders. When used effectively, these tools can highlight problem loans such as property flips.

Post endorsement technical reviews of underwriting and property appraisals are key controls in monitoring direct endorsement lenders. These technical reviews are typically a desk review of FHA case documentation after insurance endorsement. These reviews assess lender compliance with HUD underwriting and appraisal requirements. Most of this work is contracted out with contractors paid $15 to $35 per case. If problems are found during these technical reviews, HUD is to take remedial action. HUD over relied on the work of these contractors and HUD was not reviewing contractor performance. The effects of such over reliance were demonstrated by a recent case where Allstate Mortgage Company fraudulently originated over 400 FHA loans totaling $97 million. Seventeen of these loans had undergone post-endorsement reviews by a contractor. Although the 17 loan files showed obvious fraud indicators, the contractor found no significant problems. None of 17 cases had been re-examined by HUD contract monitors.

Our re-examination of 151 post endorsement reviews found that, in 70 cases, the reviews failed to disclose material underwriting errors. Our review found several reasons why HUD's controls over the post technical review process were not providing meaningful results, including:

- inexperienced staff in critical HUD control positions,
- increased loan volume with fewer staff to monitor lenders,
- no clear operating policies or procedures for Homeownership Center operations,
- outdated handbooks,
- emphasis on quantitative goals, and
- financial disincentives for contractors to find problem endorsements.

Another critical control is the systematic testing of property appraisals by HUD. The direct endorsement lender selects the appraiser that sets the value of the property for FHA insurance. With the high loan to value ratio of most FHA loans, an accurate appraisal is critical to minimizing HUD's insurance risk. HUD's procedures call for field reviews of 10 percent of all appraisals. Also, there are additional requirements that assure oversight of each appraiser's and each lender's performance and follow-up when problems are noted. During our audit we found that these controls were not being followed. Branch Chiefs at three Homeownership Centers commented that they did not have enough staff to monitor appraisers or to sanction poor performers. Since completing our audit, HUD has made significant strides in the area of improved appraiser oversight, by identifying high risk appraisers for review.

A third important control over direct endorsement lender activity is the on-site monitoring reviews to identify and correct poor origination practices. While the Quality Assurance Divisions should focus on lenders with high defaults and foreclosures, many low risk lenders were reviewed in order to meet quantitative processing goals. HUD needs to assure that limited monitoring resources are used effectively.

REO Properties- FHA contracted for the management and marketing of its single-family properties in March of 1999. Seven companies received awards for the 16 M&M contracts to manage its single-family property inventory. The objective of the contracts was to reduce the inventory in a manner that: "(1) expands home ownership, (2) strengthens neighborhoods and communities, and (3) ensures a maximum return to the mortgage insurance fund." FHA has realized some success from outsourcing. Sales volume increased and property inventories decreased. Also, contractors implemented new marketing tools such as bidding through the Internet. Sales of properties in fiscal year 2000 exceeded $5 Billion.

However, our comprehensive audit of the program found that FHA's contractors did not maximize the return to the mortgage insurance fund or maintain properties in a manner that strengthened neighborhoods and communities. FHA has had numerous other problems with the contractors, including bankruptcy by one, inability to meet contract performance deadlines, countless complaints from homebuyers and real estate professionals, and billings for ineligible costs. We found problems with all seven contracts reviewed. We computed the outsourcing of program operations to cost the MMI fund an additional $188 million. We attribute this cost to poor M&M contractor sales performance and substantially increased program costs. We believe FHA's failure to perform a cost benefit analysis in accordance with A-76 contributed to the poor program performance and loss of funds.

Officer Next Door (OND), Teacher Next Door (TND) Program- While this is a very small program, with fewer than 4,000 properties sold since its inception in 1997, it illustrates the difficulty of setting up boutique programs in HUD without sufficiently considering the staff resources needed to effectively operate them. As you know, this program allows police officers or teachers to purchase REO properties in designated revitalization areas at 50% of their appraised value. Our recently issued interim audit found a high proportion of homebuyers abusing and defrauding the OND/TND program. Seven of the 29 homebuyers we reviewed violated one or more program requirements, lenders were not executing second mortgages as required and HUD did not have an effective method of tracking suspected violations. This program reduces the recoveries on REO sales, thus impacting the financial health of the MMI fund.

What Are the Causes and Solutions?

When we become aware of a fraudulent transaction, we generally attempt to determine its cause. That is, what controls were not followed or what additional controls are needed to prevent it from happening in the future. Our investigations and audits of FHA-insured single-family loan originations have disclosed a number of common problems. First, many of HUD's well established controls were not being performed or they were performed in such a perfunctory manner as to render them useless. Another major contributing factor was HUD's 2020 Reorganization that 1) moved many HUD staff into new positions for which they had little if any training, and 2) consolidated all field operations into four Homeownership Centers. Lastly, in fiscal year 1998, HUD's single-family staff was cut in half. During this same time, FHA reached historic records of insurance activity. All these factors combined to make HUD particularly vulnerable to fraud.

Our New York Housing Fraud Initiative staff has been dealing with a major scandal in the 203(K) rehabilitation program in Harlem and Brooklyn. While the 203(K) program is part of the General Insurance Fund, not the MMI Fund, I bring this up because the cause of the problem is the same. Several non-profits fleeced HUD by getting hundreds of federally insured loans well in excess of the property value. The biggest contributing cause to this scandal was the lack of HUD staff to oversee origination practices.

FHA Single Family program staff are in the process of taking corrective actions on most of our audit recommendations. Further, we are pleased to see that the President's Blueprint for HUD is recognizing the need for FHA fraud reduction and improved program controls. The Blueprint will include actions to improve the loan origination process and provide for better monitoring of lenders and appraisers. Recognizing that HUD's single family staff have been through downsizing, reorganization, and heightened workload expectations, we need to step back and figure out how we can make the internal control requirements that are on HUD's books actually work to prevent fraud and abuse. Internal controls will not work without sufficiently trained staff to assure that checks and balances are in place. If the Congress and the Secretary of HUD send a clear message that that's what they really want, then I am confident that the single family staff will be able to figure out how to do it. The problem is, of course, that making internal controls work is generally perceived as a tedious endeavor. But that's how real work gets done.

* * * * *

Chairman Roukema, I appreciate the Subcommittee's concern about the wellness of the MMI fund. The new Secretary's team and my staff have had discussions on improvements needed in the FHA programs and we are eager to work with this new Administration to make FHA better. I thank you for the opportunity to present the views of the OIG at this hearing, and I pledge our full support for your efforts to strengthen the single-family mortgage insurance program.

HUD-OIG Responses to Questions Submitted By
Chair Marge Roukema
Subcommittee on Housing and Community Opportunity
Tuesday, March 20, 2001

Question 1A

1. Ms. Gaffney, your fiscal year 2000 audit mentions one material weakness and three reportable conditions. All four of these issues appear to relate to technology and database systems.

    A) In simple terms that this Subcommittee can understand, is it your opinion, after eight years experience, that FHA is better off than it was before? To put it another way, what are the improvements that you can see in making this program efficient and fraudulent proof?

Response 1A

In terms of the financial health of the fund, the actuarial reports support that the fund is better off than it was eight years ago. Much of that financial health is due to a sound economy, increasing home values, and high mortgage insurance premiums. Also, a growing FHA business helped in solidifying the fund's financial health. As I noted in my testimony, mortgage frauds take several years before the impact is felt. As we expand our audit and investigative effort, we are identifying an increasing number of fraudulent loans. Most frauds result from a borrower's false representation of qualifications or an overvalued property appraisal. With appreciating home values, the majority of frauds will go undetected. However, a decline in property values could rapidly change FHA's financial health. Even with the housing market as strong as it is today, about 1 in 10 FHA mortgagors are more than 30 days late in paying their mortgage according to Mortgage Bankers Association statistics.

The vast majority of FHA's business is handled through Direct Endorsement (DE) lenders. Our audit of the loan origination program two years ago found that significant improvements were needed in DE lender oversight. Many of the necessary controls were available, but they were not used effectively. While FHA activity was rising, FHA staff was declining. I think a more effective usage of existing controls is the answer.

Question 1B

B) What advice would you provide this Subcommittee on how to provide legislative remedies to assist FHA/HUD in ferreting out fraud and mismanagement?

Response 1B

Legislative remedies already exist for most of the frauds we detect. We are committed to recommending additional remedies when and if appropriate. Recently, we formed an IG task force to study past frauds and decide if additional legislative remedies are appropriate.

Question 1C

C) Given the current management/oversight structure, is the FHA program in danger if a severe economic downturn develops?

Response 1C

Yes. See our response to Question 1A.

Question 2

2. This audit references improvement from 1999. In terms of technology, how far behind is FHA in modernizing its database systems and what difference can we anticipate when that new system is implemented?

Response 2

Accounting system improvements at FHA were minor during FY 2000. FHA developed a short-term solution to some of its funds control system deficiencies, but this solution has several manual processes and therefore, is subject to delays. FHA tried to transfer its account balances to the HUD general ledger quarterly versus annually last year, but this process too was largely manual and the transfers were not timely. Account balances should be transferred monthly according to federal accounting system requirements.

FHA purchased a COTS (Commercial-Off-the-Shelf) federal accounting system, consisting of six modules, to replace the existing non-compliant commercial general ledger system and possibly other existing accounting components at FHA. The six modules purchased include the general ledger, payables, purchasing, receivables, billing, and projects. The initial module to be implemented is the federal general ledger. FHA anticipates completing the general ledger implementation in March 2002; however, implementation of an automated interface (the FHA data warehouse) is a prerequisite to successful general ledger completion. One of the warehouse functions is to automatically record various transactions that are now done on a manual basis. The warehouse is planned for completion by July 31, 2001. If and until these projects are completed, the FHA non-compliant accounting systems have basically remained the same as prior years.

Question 3A

3. While the FHA mainly relies on direct endorsement by FHA-approved lenders, you mention on page 5 of your testimony that many times FHA relies heavily on contractors. For example, you state that in almost half of your re-examination of 151 post endorsements reviews, 70 reviews failed to disclose material underwriting errors.

   A) Are you stating that HUD is contracting too much of its oversight responsibilities out to private companies?

Response 3A

HUD must assure that contractors are adequately performing their tasks. In this scenario, HUD was more concerned with quantity of reviews vs. their quality. HUD never looked behind the work of the contractor once the contractor noted that the direct endorsement lender did a satisfactory job. We recommended that contract oversight focus on the quality of work performed.

Question 3B

B) How many full-time employees should FHA have to provide adequate lender oversight?

Response 3B

I can't make that determination at this time. FHA has not yet determined the number of full-time employees it needs to provide adequate lender oversight. At present, HUD lacks a single integrated system to support resource allocation. However, an on-going study may assist HUD in addressing staffing problems department wide. HUD reported the study to Congress in the Annual Performance Plan Progress Response, dated October 18, 1999. For the past two years, the National Academy of Public Administration has worked with HUD to design and test a methodology for a resource management system, called Resource Estimation and Assessment Process (REAP). HUD believes that REAP, in combination with an automated report and validation system, called Total Estimation and Allocation Mechanism (TEAM), will provide the Department with tools to monitor and deploy workforce resources in a highly efficient manner. HUD proposed to phase in the system over an 18-month period at a projected cost of about $5 million.

Our September 29, 2000, report on the Department's progress in implementing REAP found that, despite some positive events, REAP implementation had not progressed with the urgency we would expect for a priority status project (Report No. 00-PH-169-0802). Specifically, we found delays in the contractor procurement process and inadequate contractor funding. In responding to our report, the former Deputy Secretary reported that the Department had fully funded REAP, top level management was in complete support of REAP, and the REAP project was on target. We expect to review the project's results at a future date.

Question 4A

4. You also mention on page 5 the impact of faulty appraisals and that in most of the Home ownership Centers, there were not enough staff to "monitor appraisers or to sanction poor performers." Yet, you also mention that HUD has significantly improved.

   A) Please explain how FHA is substantially impacted via faulty appraisals in terms of economic loss?

Response 4A

Appraisals are a key element in property sales because lenders will not provide mortgages unless an appraiser values the property at the sales price or higher. The ratio of amount of loan to value of property is a strong indicator of risk of claims. A fiscal year 1999 Actuarial Review of the Mutual Mortgage Insurance Fund disclosed that two-thirds of FHA's mortgages have a loan to value ratio of over 90 percent. A slight discrepancy in the loan to value ratio could have a significant impact on the insurance fund. If appraisals are faulty, the risks of loss are greater.

Question 4B

B) To what degree are there improvements and what are some key examples?

Response 4B

In June 1998, HUD unveiled a new Homebuyer Protection Plan to reinvent FHA's appraisal process and establish a new level of consumer confidence in the home buying process. The Plan's major provisions include (1) requiring a more thorough basic survey of the physical condition of the home to uncover potential problems; (2) requiring, for the first time, that home defects found by appraisers be disclosed to potential buyers; (3) imposing stricter accountability on all appraisers and tougher sanctions on those who act improperly—ranging from barring them from doing more FHA appraisals to steep fines and potential prison sentences in the most extreme cases; (4) requiring an appraiser to recommend a full home inspection if the appraiser finds a significant problem; and (5) allowing HUD funds to be used for home inspections. In July 1999, HUD issued a revised handbook for appraisers to provide clearer instructions and ensure standardization and consistency in developing and reporting appraisal findings. In addition, HUD established the Real Estate Assessment Center (REAC) in 1998 to, among other things, improve the quality of the nearly one million single family appraisals performed for new homebuyers annually. HUD hires contractors to review 10 percent of the appraisals each year. These reviews help at finding appraisers violating HUD's appraisal guidelines.

5. On page 6 of your testimony, you cite a comprehensive audit of the FHA property disposition program where FY 2000 sales exceeded $5 billion. Specifically, you state that: "FHA's contractors did not maximize the return to the mortgage insurance fund or maintain properties in a manner that strengthened neighborhoods and communities."

Question 5A

A) How do you calculate the maximum return? Do you factor-in a quick turnaround in sales?

Response 5A

In our opinion, property disposition program operations should be evaluated based on the net return to HUD as compared to the appraised value. Independent appraisers that are approved by FHA determine appraised values. Appraised values are driven by real estate market forces, including comparable property sales, and provide the best benchmark for evaluating program success and comparing performance between various periods. A quick turnaround is critical in getting a better net return as delays normally result in greater sales discounts being offered.

Question 5B

B) How do you measure FHA or the contractor's actions to "strengthen neighborhoods and communities? Are there examples where this lack of oversight destroyed neighborhoods or left them worse-off?

Response 5B

FHA assigns about 3,800 properties to the contractors monthly. Initial inspections are required to determine if imminent health or safety hazards exist, personal property remains on the premises, mortgagees conveyed properties in accordance with preservation and protection requirements, and properties are occupied. Our September 2000 report on the property disposition program found that contractors did not inspect within 24 hours about 65 percent of the properties we reviewed. Delays ranged from 1 to 43 days. When properties are not inspected and secured timely, they are subject to further deterioration and vandalism and potentially reduced return to the insurance fund. Although we could not measure the specific negative community impact, deteriorated and vandalized properties did nothing to strengthen communities, reflected poorly on the Department, and threatened the health and safety of the public.

Question 5C

C) You mention that FHA's failure to performance a cost benefit analysis in accordance with A-76 contributed to the poor performance. What is an A-76 and how does it relate to property disposition? Is FHA required to provide an A-76 comparison? If so, why not? If not, how can you state that this failure contributed to poor performance?

Response 5C

Office of Management and Budget (OMB) Circular A-76 provides policy guidance and implementing procedures for government agencies to use in deciding whether to contract out for commercial activities. Circular A-76 is a tool federal managers can employ to make sound business decisions and to enhance federal performance through competition and choice. The Department did not perform the cost benefit studies recommended in Circular A-76 when it decided to contract-out the property disposition functions. Rather, the Department obtained a determination from the Chief Financial Officer that a study was not technically required since the new contracting would not affect the jobs of more than 10 employees -- because the jobs had already been eliminated.

We determined that the first year of outsourcing property disposition activities resulted in increased HUD losses of $85 million. In our September 2000 report on the property disposition program we recognized that it is no longer feasible to perform an A-76 study; however, we recommended that FHA establish performance benchmarks and develop methods to identify when the costs of outsourcing exceed the benefits obtained.

Question 6A

6. You mention the current FHA Officer Next Door (OND) and Teacher Next Door (TND) programs, claiming that since 1997, fewer than 4,000 properties were sold **under this authority.** However, your testimony alludes to the possibility that these programs are not efficient or "impact the financial health" of the mutual mortgage insurance fund.

A) How many staff are necessary to meet a policy objective to provide home ownership to teachers and public safety officers? What is the current total of full time employees providing this program oversight?

Response 6A

Our audit was not designed to assess the number of staff needed to effectively administer the Officer and Teacher Next Door Programs. Recently, three program specialists in the Headquarters program office were working on these programs; however, they also worked on other Real Estate Owned (REO) property disposition programs, such as sales to non-profits. The number of staff needed at Headquarters, Home Ownership Centers, and M&M Contractors must be considered on a much broader basis to include all programs and functions carried out at each level.

Question 6B

B) You only reviewed 29 properties out of 4,000. Is this a good statistical sample to conclude or infer that the program is not worth it?

Response 6B

The sample of 29 cases cited in our interim report represents case reviews in one city and is not intended to be the basis for overall audit conclusions. Our final audit will report on 108 randomly selected cases in four cities, which, we believe, will provide a sufficient sample to draw audit conclusions. We selected the four cities based upon their caseloads. We also wanted to obtain a variety of locations managed by two HUD Home Ownership Centers. Because the cities were not randomly selected, a statistical projection of results to the entire program is not possible.

OIG has expressed concerns in the past that HUD has too many programs to manage effectively. The Officer and Teacher Next Door programs are examples of HUD's adding complexity and additional regulatory requirements to the overall property disposition program. To be managed effectively, each OND or TND property sale requires additional procedures beyond the normal REO sale to verify the qualifying occupation, execute second mortgages for the 50 percent discount, obtain certifications concerning the occupancy requirements, and monitor compliance during the 3-year occupancy term. Because of the added costs for administration and the 50 percent sale-price discount, which is borne by the FHA insurance fund, the OND and TND property sales will be less cost beneficial than other property sales.

Question 6C

C) How do you factor-in "strengthened neighborhoods and communities" (as mentioned under your concerns for property disposition (p. 6, second paragraph) in making a judgment that the program makes good policy?

Response 6C

HUD has not assessed whether the Officer and Teacher Next Door Programs are achieving their goals and objectives and had not made plans to do so. Therefore, HUD cannot demonstrate whether the programs are having a beneficial impact.

CBO TESTIMONY

Statement of
Marvin Phaup
Deputy Assistant Director for
Microeconomic and Financial Studies

The Federal Housing Administration's Mutual Mortgage Insurance Fund

before the
Subcommittee on Housing and Community Opportunity
Committee on Banking and Financial Services
U.S. House of Representatives

March 20, 2001

This document is embargoed until 2:00 p.m. (EST), Tuesday, March 20, 2001. The contents may not be published, transmitted, or otherwise communicated by any print, broadcast, or electronic media before that time.

CONGRESSIONAL BUDGET OFFICE
SECOND AND D STREETS, S.W.
WASHINGTON, D.C. 20515

Madam Chair and Members of the Subcommittee, I am pleased to participate in today's hearing on the Federal Housing Administration's (FHA's) Mutual Mortgage Insurance Fund (MMIF). Your letter of invitation asked that the Congressional Budget Office (CBO) address the question of whether the MMIF has a surplus that can be spent on housing needs.

The short answer to that question is clearly no. Accumulations of premiums in excess of costs, as reflected in the accounting balance attributed the MMIF, do not constitute authority to spend. The MMIF's balance does not constitute budgetary resources. Under the Credit Reform Act, fees collected from borrowers are not available to make new loan guarantees. Appropriation actions are required before FHA can obligate federal funds to guarantee new loans. Through the appropriation process, the Congress approves the making of new FHA loan guarantees by setting an annual limit on the loan volume. (In 2001, that limit is $160 billion.) It is that process—and not the existence of any balance in the MMIF—that provides the resources for FHA to make new loan guarantees.

In addition to the budgetary perspective are the actuarial and economic perspectives. The actuarial perspective, which is the focus of the annual review conducted for FHA by a contractor and to which a report by the General Accounting Office (GAO) responds, aims to assess the financial position of the MMIF in terms of its projected long-term cash inflows and outflows.[1] The economic perspective, by contrast, recognizes that the gross domestic product is the only source for funding future government obligations. That perspective assesses the success of government efforts to "reserve" funds for the future in terms of the effects on capital accumulation and the

1. Deloitte & Touche, *Actuarial Review of MMI Fund as of FY 1999* (prepared for the Department of Housing and Urban Development, January 2000), and General Accounting Office, *Mortgage Financing: FHA's Fund Has Grown, but Options for Drawing on the Fund Have Uncertain Outcomes*, GAO-01-460 (February 2001).

capacity of the economy to produce. While the actuarial and economic perspectives are both valid in principle, estimates of the extent to which the MMIF's income and costs balance each other and estimates of the MMIF's effects on the economy are too uncertain to support strong conclusions from either perspective. In any event, the MMIF has no capacity or authority to provide funding from its accounting balance to meet additional housing needs.

I would like to elaborate on this answer by observing that:

- The MMIF is a useful accounting device, but it is not a financial or corporate entity. It exists solely as a federal bookkeeping convention, albeit one that under current law has real consequences.

- Estimates of the economic value, or net position, of the MMIF provide policymakers with some useful information, but not spending authority or any other budgetary resources on which to base spending.

- Long-term estimates of the fund's balance are very uncertain, but they could have significant effects on policy.

THE MMIF'S BALANCE IS NOT A MEASURE OF BUDGETARY RESOURCES

The MMIF has no offices, no employees, and no authority to spend or do anything else other than what the Congress directs. The fund is not necessary to operate the government's mortgage insurance program for single-family housing.

Even if there was no MMIF, FHA could still have issued the $94 billion in mortgage insurance that it did in 2000, provided it had received the authority to do so through the appropriation process. The resources used by the fund are the federal government's, as are all of its obligations and liabilities for the $480 billion in loan guarantees currently outstanding.

Prior to the Credit Reform Act, many credit programs operated as revolving funds. The money that came in from fees and repayments was available for making new loans or guarantees. That arrangement is no longer the case. The authority to make new loan guarantees does not depend at all on up-front fees or on the repayments of previous loans. It simply requires appropriations (or in some cases, mandatory budget authority) sufficient to cover the costs of the loan programs.

Accordingly, it is misleading to refer to the fund as though it were a funding source on its own. No money is "deposited" or held in the fund; instead, premium receipts are consolidated with all other federal collections and managed by Treasury. The fund's balance is not an additional source of resources to the federal government, and the fund's financial position does not affect the government's ability or commitment to pay eligible claims. Rather, statements about the soundness or financial weakness of the fund should be interpreted as short-hand ways of describing whether the programs in the MMIF are operating in accord with the Congress's intent that income from premiums cover the programs' costs.

THE MMIF IS A SOURCE OF SOME USEFUL BUT UNCERTAIN INFORMATION

The fund is a means of tabulating and reporting actual and projected inflows of cash from premiums and outflows of the programs' cash costs. Monitoring the long-term balance between income and costs is extraordinarily difficult because of the long life of mortgage insurance contracts (up to 30 years), differences in the timing of premium receipts and payments for defaults, and the uncertainty of future economic conditions and policy changes that can affect both premium receipts and program costs.

Consequently, the balance between premiums and costs cannot be determined solely from recent experience. Assessing the long-run position of the fund requires adding the accumulated position from past guarantees to the projected cash inflows and outflows from all outstanding guarantees. As is well known, those projected future flows depend greatly on such unpredictable variables as interest rates, which affect loan prepayments, and house prices, which affect the frequency and costs of defaults.

Currently, the Subcommittee has at least two independent estimates of the net position of the MMIF as of the end of 1999: one from Deloitte & Touche, of $16.6 billion, and one from GAO, of $15.8 billion.[2] Both seem carefully done. Given their assumptions about the future, both conclude that current policy is consistent with the objective that premiums cover costs.

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2. A new study of the fund's position at the end of 2000 has recently been released: Deloitte & Touche, *Actuarial Review of the Federal Housing Administration's Mutual Mortgage Insurance Fund as of Fiscal Year 2000* (prepared for the Department of Housing and Urban Development, December 2000).

As the GAO report demonstrates, however, various economic episodes that have occurred in the past could decrease the net position of the MMIF if they recurred. Thus, while it is useful to measure and monitor the fund's balance, estimates of the fund's net position are uncertain approximations of the true long-term relationship between premiums and costs. In any event, they are not a measure of the budgetary resources available to finance the fund's activities.

UNCERTAIN ESTIMATES OF THE MMIF'S BALANCE COULD HAVE REAL CONSEQUENCES

Under current law, estimates of the fund's financial balance can affect the terms under which federal mortgage insurance is offered to the public. The Congress has established a target value for the net position of the MMIF equal to 2 percent of insurance in force. If the estimated net position is above that threshold, the Secretary of Housing and Urban Development has discretion under current law to reinstitute the payment of distributive shares (rebates of insurance premiums to borrowers who prepaid their mortgages or otherwise terminated their mortgage insurance). The Secretary also has discretion to reduce the initial price of the insurance or to modify the underwriting standards.

Under current law, such policy changes are to be made only after the Secretary gives due consideration to the effects of those changes on the net position of the fund and to the need to minimize risks to the fund. The effects of such policy changes on the long-term balance of the fund are very difficult to estimate, and such estimates must be viewed as uncertain.

CONCLUSION

From all indications, Congressional efforts to ensure that the costs of programs included in the MMIF are paid for from premiums are succeeding. No one can be absolutely sure, but the estimates of the fund's net position—even with a 2 percent allowance for uncertainty—are consistent with that conclusion.

Nevertheless, it is clear that accumulations of premiums over costs in the MMIF do not constitute authority to spend more money on housing programs. Only the Congress, through the appropriation process, can provide FHA with the authority to make new loan guarantees.

Steps could be taken to improve the information available about the financial condition of the MMIF. One step would be to develop systematic estimates of the expected volatility of the fund's net position based on the assumption that policy is unchanged. That endeavor would help assess the adequacy of the 2 percent reserve. Further, as the GAO report emphasizes, policymakers need better information on the effects of specific policy changes on the MMIF's financial balance. The understanding of those relationships is crude but improving; significant advances in analysts' ability to project the effects of policy changes, including changes in the underwriting standards, can be anticipated over the next several years. Armed with that information, the Congress will be better able to ensure that premiums pay the long-term costs of insurance. In the meantime, the Congress needs to be fully aware of the useful aspects but qualitative limitations of the current estimates of the MMIF's net position.

ANSWERS TO QUESTIONS
BY

SUBCOMMITTEE RANKING MEMBER LAFALCE
TO THE

CONGRESSIONAL BUDGET OFFICE

1. For both fiscal year 2001 and 2002 what is CBO's projection of: (a) the profit or credit subsidy per FHA loan, as a percentage of loan amount, (b) the budgetary profits (credit subsidy) for the national book of FHA loans?

   The estimated subsidy rate for both 2001 and 2002 is approximately -2 percent. That negative subsidy rate indicates that, on a present-value basis, MMI programs are estimated to record net negative subsidies (the amounts by which estimated receipts over the life of loan guarantees issued in a year will exceed the estimated expenditures associated with those same guarantees). CBO estimates that net receipts for each of fiscal years 2001 and 2002 will be approximately $2 billion.

2. Recently, CBO and OMB moved the negative credit subsidies associated with the FHA single family program from the mandatory to the discretionary side of the budget. Can you explain the budgetary impact of this with respect to (a) HUD net budget totals in the VA-HUD appropriations bill, (b) discretionary caps, and (c) the federal unified budget surplus or deficit.

   The reclassification is technical and should neither help nor harm HUD, MMI programs, or any Congressional committee. The negative credit subsidies will be assigned to the appropriators each year. As a result, HUD's net budget totals in the VA-HUD appropriation bill should decline. However, that net decline in discretionary spending should be offset by an equivalent increase in net mandatory spending by HUD. Thus, in total (discretionary and mandatory spending), HUD's net spending should be no higher or lower as a result of the reclassification. Similarly, OMB is required to adjust the level of the discretionary cap set in law for 2002 downward to offset the increase in the amount of resources available to the appropriators from the negative subsidy receipts (in order to hold the committee "harmless"). (Caps constructed by the Congress for 2003 and beyond will take the new classification into consideration as well.) Finally, because the reclassification is only a technical accounting change, it should have no impact on the unified federal budget or the amount of the federal surplus each year.

ANSWERS TO QUESTIONS
BY

SUBCOMMITTEE CHAIR ROUKEMA
TO THE

CONGRESSIONAL BUDGET OFFICE

1. Mr. Phaup, the Committee Staff learned that CBO and OMB scored FHA single family receipts by $2.2 billion on the discretionary side rather than the mandatory side, as has been done in the past. There are some that believe this change in scoring acknowledges the use of FHA receipts for discretionary programs such as HOME or a new housing program.

    A. Could you explain in layman's terms what occurred in the most recent FY 2002 budget blueprint and what does that mean in terms of housing programs? Some may not understand the importance of mandatory and discretionary. Could you explain that concept in your answer?

    The conference report to the Balanced Budget Act of 1997 requires the Congressional Budget Office (CBO), the Office of Management and Budget (OMB), and the budget committees (collectively, the "scorekeepers") to review annually the scorekeeping guidelines adopted as part of the conference report and to discuss other budgetary issues, such as reclassifying accounts (for example, from mandatory to discretionary or from budgetary to nonbudgetary). As part of that process, the scorekeepers agreed, after extensive discussion, to reclassify the Federal Housing Administration's (FHA's) Mutual Mortgage Insurance (MMI) programs as discretionary rather than mandatory. (The authority to spend for mandatory programs is determined by laws other than annual appropriation acts, whereas appropriation acts provide budget authority for discretionary spending. Mandatory spending must comply with the pay-as-you-go rules of the Budget Enforcement Act [BEA], whereas discretionary spending must comply with the BEA's discretionary spending caps.)

    The new classification recognizes that MMI programs receive their authority to operate each year from the maximum commitment level for loans that is provided by the appropriations committees. That need for a specific commitment level is consistent with the Federal Credit Reform Act of 1990, which requires annual appropriation action for all nonentitlement credit programs. In addition, the *reclassification of MMI programs makes their treatment consistent with that of Ginnie Mae and FHA's General and Special Risk Insurance programs, which perform similar activities and are closely linked with MMI programs.*

B. Specifically, does a change from mandatory to discretionary, as it relates to FHA receipts provide HUD with spending flexibility? If so, how? If not, why not?

That reclassification is technical and should have no effect on the amount of budgetary resources available to the Department of Housing and Urban Development (HUD), MMI programs, or any Congressional committee. The budget scorekeepers will now simply account for MMI program spending under a different category (that is, discretionary), while the programs continue operating as they did prior to the reclassification.

Whenever a program is reclassified from mandatory to discretionary (or vice versa), OMB is required to adjust the amount of the discretionary caps set in law (upward or downward) to reflect the change in discretionary spending brought about by that reclassification. Similarly, the new classification will be taken into consideration if new caps are created for 2003 and beyond (or if the 2002 cap is revised). The change in classification should also be reflected in the allocation to the appropriators included in this year's budget resolution. Finally, the new classification represents no change in HUD's spending authority, but rather reflects more accurately the existing authority for MMI programs.

2. I understand that CBO provided similar information to the Senate Banking Committee last year regarding the concept of a FHA surplus. However, many of our Members have been approached about the so-called surplus and to what extent those funds can be used for other housing purposes.

A. Could you clarify what represented the $5 billion surplus figure announced last year? How was that $5 billion calculated and based on that calculation, does that $5 billion figure exist today? [staff learned that the $5 billion could be $300 million]

CBO's October 23, 2000, letter to Sen Allard stated:
"The $5 billion amount referred to by the Department of Housing and Urban Development (HUD) is the difference between estimates of the Mutual Mortgage Insurance Fund's (MMIF's) economic net

worth at the end of fiscal year 1998 and at the end of fiscal year 1999. That difference reflects an additional year of loan guarantee activity, as well as the fact that the two estimates were done by different contractors, at different times, using different economic models and assumptions.

The Cranston-Gonzalez National Affordable Housing Act (NAHA) requires the Federal Housing Administration's (FHA's) MMIF to undergo an independent actuarial review annually. The independent reviewers use their own models to evaluate the financial soundness of the MMIF. The results of such a review are only preliminary because the data available at the time do not include actual results for the full fiscal year and because NAHA also requires that the FHA undergo a financial audit after the fiscal year is over.

The 1999 actuarial review, prepared by Deloitte & Touche, estimates that the MMIF had an economic net worth of $16.6 billion at the end of September 1999. The fund's economic net worth consists of the assets credited to the fund, mostly in the form of Treasury securities but also including the estimated discounted present value of future cash flows, less the fund's liabilities. Cash receipts to the MMIF come mostly from premiums charged to home buyers and receipts associated with the sale of foreclosed property. Outlays are primarily for claims payments. FHA provides mostly 30-year loan guarantees, so the estimated cash flows for a given group of loan guarantees are projected well into the future.

Compared to the estimated economic net worth of $11.4 billion at the end of September 1998 (as estimated by Price Waterhouse Coopers), this new amount represents a $5.3 billion increase in the fund's estimated value. This amount, which some have referred to as a "surplus," thus represents the change in the preliminary, actuarial estimate of the MMIF's economic net worth from fiscal year 1998 to fiscal year 1999. About half of the increase represents the estimated net value of the fund's 1999 activity; the other half results from new assumptions and new methodologies used to project the value of future cash flows."

Since the time of that letter, Deloitte & Touche has completed its actuarial study for fiscal year 2000. From October 1, 1999, to October 1, 2000, Deloitte & Touche estimates that the value of the MMIF increased by roughly $300 million, from $16.7 billion to $17.0 billion. That increase is small (relative to the $5 billion increase *estimated during fiscal year 1999) partly because the fiscal year 1999 valuation was reestimated to be nearly $2 billion less than before. That is, Deloitte & Touche now estimates that the $5.3 billion increase in the Fund's value initially reported for fiscal year 1999 was overstated by $2 billion; a more accurate estimate of the Fund's increased value in that year is only $3.4 billion. The large difference from reestimating was due to two primary factors. First, Deloitte & Touche completed its fiscal year 1999 actuarial study before it had access to audited financial statements for that year; without those financial statements, it overestimated the beginning-of-year resources in the Fund by $1 billion. Second, Deloitte & Touche's econometric model of mortgage performance significantly underestimated the default and prepayment rates of insured mortgages. That factor, too, caused an overestimation of the Fund's value of roughly $1 billion. Both of those problems were addressed in the fiscal year 2000 actuarial study. The result was the small net increase of $300 million in the Fund's value reported for fiscal year 2000.*

B. For the $5 billion or the revised amount to be spent, what exactly must Congress enact and what impacts will that law have on balancing the budget?

As stated in my testimony, the MMIF is a convenient accounting device for recording the balance of payments between FHA insurance programs and the budget, but it does not provide any budgetary resources for spending. Legislation that provides for any additional spending authority for HUD would add to federal outlays and reduce projected budget surpluses, just as any other additional spending would.

3. You conclude on p. 2 that "long-term estimates of the fund's balance are very uncertain, but they could have significant effects on policy."

A. If there is so much uncertainty, then what are we measuring?

Measuring the MMIF's cash flows is an imperfect process, mainly because of the uncertainty surrounding estimates of future cash flows. The balance in the MMIF is the sum of two components: the sum of past cash flows on outstanding, expired, and canceled insurance contracts and the sum of expected future cash flows on outstanding insurance contracts.

Information about the MMIF's balances can provide policymakers with useful information on the performance of MMI programs, however, as long as such information is understood in context. In particular, the true long-term relationship between premiums and costs in MMI programs is the key performance measure. Reporting and analyzing MMIF balances, and sources of changes in those balances over time, can be important tools for understanding if the programs are self-supporting.

B. What warning signs should Congress acknowledge before enacting FHA policies that may damage the insurance fund?

Warning signs that the Congress should acknowledge before making substantive changes in FHA's policies for the MMIF includes these:

o When budget subsidy estimates are made during times of economic strength–with low unemployment and growing property values;

o When little attention is given to the sensitivity of budget subsidy estimates to regional and national recessions; and

o When such policies include the potential for significant volumes of new mortgage products designed to increase access to homeownership by low- and moderate-income households—for such products have, in the past, exhibited greater credit risk than originally anticipated.

4. On page 2 of your testimony, you state that the economic perspective recognizes that the gross domestic product is the only source for funding future government obligations and that perspective assesses the success of government efforts to "reserve" funds for the future.

A. In your opinion, is Congress providing the right type of measurement to assure the mutual mortgage insurance fund has the right amount of reserves?

The "right type of measurement" would be one that was useful in assessing the programs' performance, specifically, whether MMI programs are self-supporting over the long run. The current measure provides some indication of that dimension of performance. However, the continuing search for the "right amount of reserves" appears to be misplaced. Under credit reform, reserves to cover *expected losses are already included in subsidy costs in the budget. From that perspective, any reserve greater than zero, including the current 2 percent minimum, is redundant.*

B. How should Congress redefine the capital ratio requirements to reach a more accurate gauge of financial soundness?

The rationale for a capital ratio is to ensure that MMI programs are self-supporting through a wide range of economic conditions. A redefinition of the capital requirements could focus more directly on that issue, for example.

5. PREMIUM REDUCTIONS/REBATES: On page 3 of your testimony, you state that the Mutual Mortgage Insurance Fund's balance is not a measure of budgetary resources. Further, you mention that statements on the fund are "short-hand ways of describing whether the programs in the [mutual mortgage insurance fund] are operating with—the intent that income from premiums cover the program's costs.

A. What should Congress review and consider when mortgage insurance premiums far outpace the program's costs? When revenue exceeds the program's costs, is it probable that the premiums are over-priced?

The Cranston-Gonzales National Affordable Housing Act of 1990 set one primary financial goal for MMI programs: that they be actuarially sound as defined by maintaining positive capital. In the ensuing 10 years, the programs have far surpassed that goal. The Congress may now wish to revisit the issue of financial goals for the programs.

At the same time, the Congress has already put in place an automatic mechanism for returning excess funds to insured borrowers through what are commonly known as "distributive shares." Those shares may be paid out at the discretion of the Secretary of HUD (12 USC 1711(c)) but have not been paid since the temporary Congressional moratorium (provided for in NAHA to protect the solvency of the Fund until the required capital ratio should be reached). In NAHA, the Congress also directed the Secretary to stop paying distributive shares if MMI programs were not "meeting the needs of homebuyers with low downpayments and first-time homebuyers by providing access to mortgage credit" (12 USC 1711(h)(2)(B). That directive creates a second avenue for using excess premiums from MMI programs. Yet in stating that objective for homeownership, the

Congress directed the Secretary to also be mindful of "minimizing the risk to the Fund and to homeowners from homeowner default" (ibid., part(C)).

B. What recommendations, if any, are you prepared to make regarding a premium structure reduction to align more of the income with the expenses of the fund?

CBO is not prepared to make any recommendations at this time. However, in response to a request by former Chairman Lazio, we are building an in-house capacity to analyze questions of financial solvency and the balance between FHA's premiums and risks.